FOR AGENDA

SM/10/46

February 26, 2010

To: Members of the Executive Board

From: The Secretary

Subject: **Facilitating Mobilization of Loan Resources for Concessional Lending to Low-Income Countries**

Attached for consideration by the Executive Directors is a paper on facilitating mobilization of loan resources for concessional lending to low-income countries, which is tentatively scheduled for discussion on **Wednesday, March 17, 2010.** Issues for discussion appear on pages 17 and 18.

The staff does not propose the publication of this paper after the Executive Board completes its discussion.

Questions may be referred to Mr. Powell (ext. 36932) and Mr. Ralyea (ext. 38055) in FIN, and Ms. Weeks-Brown (ext. 36896) and Mr. Steinki (ext. 38222) in LEG.

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INTERNATIONAL MONETARY FUND

Facilitating Mobilization of Loan Resources for Concessional Lending to Low-Income Countries

Prepared by the Finance and Legal Departments
(In consultation with the Strategy, Policy, and Review and Statistics Departments)

Approved by Andrew Tweedie and Sean Hagan

February 26, 2010

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Executive Summary

Background

- In July 2009, the Executive Board approved a comprehensive reform of the Fund's lending facilities and financing framework for low-income countries (LICs). These reforms became effective on January 7, 2010, when all existing lenders and subsidy contributors consented to the related amendments of the PRGT Instrument. The Managing Director has approached a wide spectrum of the Fund's membership to seek bilateral contributions in support of this reform. The fund-raising has aimed to mobilize SDR 9 billion in new loan resources and SDR 0.2–0.4 billion in subsidy contributions (end-2008 NPV terms).

- To date, pledges of new loan and subsidy contributions amount to SDR 7.5 billion and about SDR 80 million, respectively. Most (about SDR 6 billion) of the new loan resources committed are expected to be provided in SDRs. Several other members have indicated that they are also inclined to contribute and that clarification of the lending framework could help facilitate their commitments. It is urgent that additional resources be forthcoming to ensure full funding of the new LIC facilities.

Issues and Proposed Approaches

- **Reserve assets.** Several members consider it essential for their new lending to the PRGT to qualify as reserve assets. This is because the financial resources these members intend to contribute, particularly SDRs, are currently part of their reserve assets.

  - **Proposal.** *The PRGT would be amended to allow for encashment of outstanding claims from members who choose to participate in an encashment regime. All new lenders would be encouraged to participate in the regime. Additional resources beyond the targeted SDR 9 billion in new loan resources would be needed to provide a liquidity buffer to allow encashment.*

- **PRGT notes.** Some members would like the option to purchase notes from the PRGT as an alternative to traditional loan agreements. They believe that this option could help facilitate their contribution of the needed loan resources.

  - **Proposal.** *A framework similar to the one for notes issued under Note Purchase Agreements (NPA) for General Resource Account (GRA) borrowing would be established under the PRGT to allow the Trust to issue notes to interested lenders. PRGT loan agreements and NPAs would have the same financial terms.*

- **SDR conversion.** With higher SDR lending expected, a number of members have enquired about the capacity of the existing voluntary SDR trading arrangements and how SDR transactions arising from PRGT loans would be handled.

    - **Proposal.** *Taking into account the potential volume of SDR conversions and the available trading capacity under the current voluntary arrangements, it is proposed that SDR conversions related to PRGT loans would be conducted through the existing voluntary system. Under the current procedures for allocating SDR sales across the voluntary trading arrangements, it is expected that those members providing SDR loans to the PRGT would also be responsible for converting the bulk of those SDRs into freely usable currencies.*

- **Maturities and interest rates**: Some members asked whether they could lend for shorter maturities than those under traditional loan agreements and enquired about the interest rate on SDR loans/notes.

    - **Proposals.** *PRGT borrowing could be structured to provide for shorter maturities (say, one year) for drawings under loan/note purchase agreements, with the provision that the Fund, as Trustee, has the discretion to unilaterally extend the maturity up to 10 years. It is further proposed that the PRGT would pay the 3-month official SDR interest rate quarterly on loans in SDRs, but continue to pay the derived six-month SDR interest rate on loans in currencies.*

- **Safety of loan resources to the PRGT.** Some members enquired about the safety of their new loan resources to the PRGT and asked for further analysis of the adequacy of the PRGT Reserve Account.

    - **Proposal.** *The Fund, as Trustee, maintains an excellent track record of debt service to Trust lenders. In case of late payment by LIC borrowers, the Trust has been able to temporarily tap the resources in the Reserve Account to meet its obligations to lenders. Staff's further analysis indicates that the balances in the Reserve Account will continue to provide adequate security to PRGT lenders/note purchasers going forward.*

- **Legal requirements.** The proposed encashment regime for PRGT claims, note issuance under NPAs, and quarterly payment of interest on loans in SDRs will require amendments to the PRGT Instrument and consents from all existing Trust lenders. The proposals on maturities and payment of the 3-month official SDR interest rate to SDR lenders could be implemented on the basis of the current PRGT Instrument. Relevant decisions will be proposed for Board adoption following the discussion of this paper.

I. Introduction

1. **In July 2009, the Executive Board approved far-reaching reforms of the Fund's concessional lending facilities for low-income countries (LICs)**. These reforms created a new architecture of facilities that is more flexible and tailored to the increasing diversity of LICs and their needs.[1] As part of the reform package, the Board also approved a new concessional financing framework, and the PRGF-ESF Trust was renamed the Poverty Reduction and Growth Trust (PRGT). These reforms became effective on January 7, 2010, when all current lenders and subsidy contributors to the Trust provided their consent to the relevant amendments of the PRGT Instrument.[2]

2. **As discussed in SM/09/158, to meet projected demand for concessional financing through 2014, loan resources of SDR 11.3 billion and subsidy resources of SDR 2.5 billion (in end-2008 NPV terms) would be needed**.[3] Given currently available resources, this implies a need to mobilize additional loan resources of SDR 9 billion and new subsidy resources of SDR 1.5 billion. The Board agreed that, as in the past, the required loan resources will be sought through bilateral contributions. Most of the needed subsidy resources, however, would come from the Fund's internal resources, including use of resources linked to gold sales, with additional bilateral subsidy contributions of SDR 0.2-0.4 billion being sought to complete the financing package.

3. **To mobilize the needed resources, the Managing Director has approached a wide spectrum of the Fund's membership**. To date, ten members have pledged to provide SDR 7.5 billion in additional loan resources (Table 1) and more than a dozen members have agreed to contribute SDR 80 million in subsidy resources. Several members have indicated that they are in the process of finalizing their decisions to contribute. Most of the members that have pledged loan resources have indicated that they plan to use part of their recent allocations of SDRs for this purpose. In addition, a number of members have expressed interest in contributing loan resources and indicated that the inclusion of certain features in the lending framework would facilitate their contributions.

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[1] *The Chairman's Summing Up Financing the Fund's Concessional Lending to Low-Income Countries—Further Considerations: A New Architecture of Facilities for Low-Income Countries and Reform of the Fund's Concessional Financing Framework—Supplementary Information and Revised Proposed Decision* (BUFF/09/131, 7/28/09).

[2] *A New Architecture of Facilities for Low-Income Countries—Notification of Effectiveness of Executive Board Decision and Update on Fund-Raising* (EBS/10/5, 1/8/10).

[3] *Financing the Fund's Concessional Lending to Low-Income Countries—Further Considerations* (SM/09/158, 6/26/09).

Table 1. New Loan Commitments to the PRGT
(In millions of SDRs)

Pledges in currencies	**1,500**
Canada	500
Denmark	200
Netherlands	500
Norway	300
Pledges in SDRs	**6,005**
France	1,250
Italy	800
Japan	1,800
Korea	500
Spain	405
United Kingdom	1,250
Total	**7,505**

Source: Finance Department.

4. **In discussions with potential loan contributors, a number of important issues have arisen**. Several lenders have stressed the importance of their loan contributions qualifying as reserve assets. Others have expressed a preference for purchasing notes rather than providing bilateral loans, and some wish to provide loans for a shorter maturity than those traditionally applying on PRGT lending. Questions have also been raised about how agreements to lend SDRs to the PRGT would be treated under the voluntary SDR trading system.

5. **This paper discusses these issues and outlines a possible framework that would seek to accommodate the needs of potential loan contributors**. In light of Directors' views, staff plans to come back the Board with a set of draft decisions that would implement the proposed new framework.

II. Current PRGT Borrowing Modalities and Practices

6. **The Fund's concessional lending operations are conducted outside the GRA**. These operations are mainly conducted through Trust arrangements (in particular the PRGT and previously the ESAF, PRGF, and PRGF-ESF Trusts, respectively), with the Fund acting as Trustee.[4] With respect to loan resources, the Trust borrows from central banks, governments, and official institutions through the loan accounts of the Trust, largely at market-related interest rates, and lends the borrowed resources to PRGT-eligible members.

[4] Concessional financing has also been provided through administered accounts, such as the administered account that provides subsidies for qualifying EPCA/ENDA purchases of PRGT-eligible members.

The Trust's loan accounts effectively serve as pass-through accounts, drawing on the lenders and disbursing to PRGT-eligible borrowers. Drawings by the Trust on commitments from individual lenders are made, to the extent possible, to maintain broad proportionality of drawings relative to commitments of individual lenders.

7. **Since the establishment of the ESAF in 1987, total loan contributions committed to the Trust have amounted to SDR 17 billion** (Table 2). Most of this total (SDR 16 billion) involved loans committed by 13 lenders in freely usable currencies, while a relatively small part (SDR 1 billion) involved commitments by four lenders to lend directly in SDRs. The key financial terms under the existing loan agreements are largely standardized:[5]

- **Grace period and repayment.** Most loan agreements provide for drawings to be repaid in ten equal installments beginning 5½ years after the drawdown date, in line with repayments by PRGT-eligible borrowers.[6]

- **Interest.** Interest is paid to lenders semi-annually, normally at the prevailing six-month market interest rates of the four underlying currencies in the SDR basket (i.e., U.S. dollar, Euro, British pound, and the Japanese yen). This derived 6-month SDR interest rate has been paid both on borrowing in freely usable currencies and in SDRs.

- **Transfer of claims (but no encashment).** All bilateral loan agreements allow for the transfer of claims among members and the suspension of drawings under certain conditions. However, there is no provision for early repayment in cases of lenders' balance of payments need (i.e., encashment) in bilateral loan agreements.[7]

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[5] From the establishment of the ESAF in 1987 until 2006, borrowing agreements were approved by the Executive Board with largely standardized terms. In 2006, to eliminate the need for Board approval of routine contribution agreements, the PRGF-ESF Trust Instrument was amended to provide the Managing Director with the authority to enter into borrowing agreements on behalf of the Trust, while informing the Executive Board regularly of the status of progress in mobilizing resources for PRGF-ESF operations (see EBS/06/24, 2/22/06).

[6] Exceptions are the three loan agreements with KfW (1989, 1995, and 2000) and the 1988 loan agreement with the Bank of Spain. These agreements provided for an initial maturity of six months for each drawing; however, the Fund, as Trustee, may request that the drawing be renewed up to ten years, which the borrowers were to consider sympathetically and were expected to agree to such requests (see EBS/99/240, 12/30/99 and EBS/88/101, 5/25/88). An accompanying Memorandum of Understanding to the KfW agreement clarified that the renewal of a drawing was the normal course of action, and that KfW would only be unable to agree to a requested rollover if one or more of the SDR basket currencies were unavailable to the KfW at the time of renewal.

[7] The PRGT Instrument provides for a transfer regime among "electing lenders" to address temporary liquidity needs (Section VI, Paragraph 2). Until now, however, no lender has indicated to the Trust an intention to participate in this regime.

Table 2. Trust Loan Agreements

(In millions of SDRs; as of end-January 2010)

	Effective date of agreement	Loan commitments
ESAF, PRGF, and PRGF-ESF Trusts		
Belgium		
National Bank of Belgium	Jul. 2, 1999	350.0
Canada		
Government of Canada	Feb. 22, 1989	300.0
Government of Canada	May 9, 1995	400.0
China		
Government of China	Jul. 05, 1994	200.0
Denmark		
National Bank of Denmark	May 3, 2000	100.0
Egypt		
Central Bank of Egypt	Jun. 13, 1994	155.6
France		
Agence Française de Développement	Apr. 05, 1988	800.0
Agence Française de Développement	Jan. 03, 1995	750.0
Agence Française de Développement	Dec. 17, 1999	1,350.0
Agence Française de Développement	Aug. 20, 2009	670.0
Germany		
Kreditanstalt für Wiederaufbau	Mar. 31, 1989	700.0
Kreditanstalt für Wiederaufbau	May 17, 1995	700.0
Kreditanstalt für Wiederaufbau	Jun. 19, 2000	1,350.0
Italy		
Bank of Italy 1/	Oct. 04, 1990	370.0
Bank of Italy 1/	May. 29, 1998	210.0
Bank of Italy	Mar. 1, 2000	800.0
Japan		
Japan Bank for International Cooperation 2/	Apr. 12, 1988	2,200.0
Japan Bank for International Cooperation 2/	Oct. 05, 1994	2,934.8
Korea		
Bank of Korea	Apr. 20 1989	65.0
Bank of Korea	Jun. 20, 1994	27.7
Netherlands		
Bank of the Netherlands	Sep. 29, 1999	450.0
Norway		
Bank of Norway	Apr. 14, 1988	90.0
Bank of Norway	Jun. 16, 1994	60.0
OPEC Fund for International Development 3/	Dec. 20, 1994	37.0
Spain		
Bank of Spain	Jun. 20, 1988	216.4
Government of Spain	Feb. 08, 1995	67.0
Bank of Spain	Feb. 14, 2000	425.0
Switzerland		
Swiss Confederation	Dec. 23, 1988	200.0
Swiss National Bank	Jun. 22, 1995	401.7
Subtotal		16,380.2
Associated Agreement-Saudi Fund for Development (SFD)	Feb. 27, 1989	49.5
PRGT Trust		
Denmark		
National Bank of Denmark 4/	Jan. 28, 2010	200.0
Spain		
Bank of Spain	Dec. 17, 2009	405.0
Subtotal		605.0
Total Loan and Associated Loan Agreements		17,034.7

Source: Finance Department.

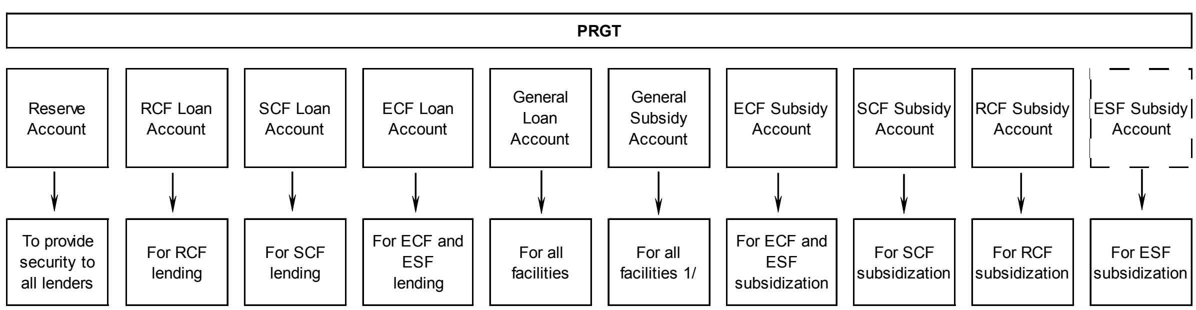
1/ In late 1999, the Bank of Italy replaced the Ufficio Italiano dei Cambi as lender to the PRGF Trust.
2/ On October 1, 1999, the Export-Import Bank of Japan merged with the Overseas Economic Cooperation Fund and became the Japan Bank for International Cooperation.
3/ The loan commitment is for the SDR equivalent of US$50 million.
4/ The commitment of SDR 200 milllion covers outstanding drawings and accrued interest.

Loan security. All loan resources are protected by the Reserve Account of the Trust. The Reserve Account both provides security to the lenders and absorbs temporary mismatches between repayments from borrowers and payments due to lenders.

8. **In a major reform approved in July 2009, the Board created three new facilities under the PRGT with differing maturities to meet the needs of LICs**.[8] Drawings under the Extended Credit Facility (ECF) and the Rapid Credit Facility (RCF) are to be repaid in ten equal installments beginning 5½ years after the drawdown date, and drawings under the Stand-by Credit Facility (SCF) are to be repaid in nine equal installments beginning four years after the drawdown date. There is no interest charge on all three lending facilities through end-2011, with the interest rate structure to be reviewed and determined by the Board thereafter.[9]

9. **The Board also decided to increase the flexibility of the Fund's concessional financing framework under the PRGT**. It was decided that a General Loan Account and a General Subsidy Account be established to receive and provide financing for all LIC facilities under the Trust. In addition, special loan and subsidy accounts for each of the three new facilities enable members to earmark their contributions for particular facilities, if they wish to do so (Figure 1).

Figure 1. Current Concessional Financing Framework



1/ Limited transfers can be made from the General Subsidy Account on an "as needed" basis to subsidize purchases of ENDA/EPCA credit outstanding as of January 7, 2010.

III. Facilitating Mobilization of Loan Resources

10. **In light of the sharp increase in concessional lending to LICs in 2009, available loan resources under the PRGT have fallen to near record lows**. As of end-January 2010, uncommitted loan resources under the PRGT amounted to about SDR 660 million, including loan resources of SDR 605 million under recently concluded borrowing agreements with the

[8] *A New Architecture of Facilities for Low-Income Countries* (SM/09/160, 6/26/09).

[9] *A New Architecture of Facilities for Low-Income Countries and Reform of the Fund's Concessional Financing Framework—Supplementary Information and Revised Proposed Decision* (SM/09/189, Supplement 1, 7/20/09).

Bank of Spain (SDR 405 million) and Danmarks Nationalbank (SDR 200 million). These resources are only sufficient to cover expected demand for a few more months. It is, therefore, urgent that additional loan resources be secured expeditiously. In this context, recent pledges by member countries to provide additional loan resources, including use of their SDR holdings, are timely and welcome.

11. **Given the issues raised by potential loan contributors in the context of the current fund-raising, staff proposes to modify the current borrowing framework to meet members' preferences**. This section explores the possibility of establishing an encashment regime to allow lending to the PRGT to qualify as reserve assets, and a framework to allow the PRGT to issues notes as an alternative to traditional loan agreements. It also discusses the possibility of providing shorter maturities than those under current loan agreements and issues concerning interest rates on SDR and currency loan resources. While individual members may have different needs, implementation of the proposed framework for the benefit of low-income members will require the cooperation of all members.

A. Encashment of PRGT Claims

12. **As noted above, several members consider it essential for their new loan contributions to the PRGT to qualify as reserve assets**. This is particularly important for a number of members planning to lend SDRs, which are counted as part of their international reserves. At the initiation of the ESAF in 1987, claims on the Trust under borrowing agreements could be considered reserve assets, consistent with the statistical reporting requirements applicable at that time. Moreover, the Board confirmed that the Fund could consider lending to the ESAF as part of a member's official reserves.[10] The reserve asset status of claims on the PRGT may be most relevant for members where the lending institution is a central bank, but it could also apply in other cases.

13. **Statistical reporting standards have since tightened and new loan contributions to the PRGT would no longer quality as reserve assets if they are not readily repayable in case of need**. Specifically, under the most recent editions of the Balance of Payments Manuals (i.e., BPM5 and BPM6), loan resources to the PRGT would not qualify as reserve assets unless they were *readily repayable* to meet a balance of payments financing need. Thus, to allow claims on the PRGT to be classified as reserve assets, it is necessary that such claims be liquid at the time of a balance of payments need.

14. **To meet this requirement, staff proposes to establish an encashment regime under the PRGT**. Under this framework, which is similar to the encashment regime under recent bilateral GRA borrowing agreements, the PRGT would provide participating

[10] *The Chairman's Remarks at the Conclusion of the Discussion on the Enhancement of the Structural Adjustment Facility—Legal Documentation* (EBM/87/176, 12/18/87).

lenders/note purchasers with the right to request early repayment of outstanding claims in case of balance of payments need. Participating lenders/note purchasers, on the other hand, would need to agree that drawings under their borrowing agreements with the PRGT could be made to fund the early repayment of other participating lenders that face a balance of payments need. Relatively broad participation by lenders/note purchasers would be critical for such a regime to work. Accordingly, all new PRGT lenders/note purchasers would be strongly encouraged to participate in encashment. Existing lenders would be able to participate with respect to the undrawn balance of their commitments.

15. **To encash an outstanding PRGT claim, a participating lender/note purchaser would represent that its balance of payments and reserve position justify early repayment**. The Fund, as Trustee, would give this representation the overwhelming benefit of any doubt. The Fund would repay the lender by drawing down resources committed to the PRGT by other participating lenders. These other participating lenders in turn would stand in the shoes of the encashed lender as regards the repayment of the claims arising from encashment, including in connection with the allocation of payments received by the Trust from LIC borrowers. While lenders may earmark their resources to a particular PRGT loan account under the newly effective concessional financing framework, for the encashment regime to work effectively, the committed resources would also have to be available for the encashment of outstanding claims on other loan accounts of the Trust.

16. **To ensure that sufficient resources are available to meet requests for encashment, a liquidity buffer would be needed as part of loan resource mobilization**. This could be composed of a portion of undrawn loan commitments provided by participating lenders/note purchasers, which could be tapped for meeting requests for encashment. Since the ability to encash PRGT claims would be subject to availability of resources in PRGT loan accounts, it would be important that an adequate liquidity buffer is maintained throughout the life of PRGT loans.

17. **It is difficult to determine the precise size of a liquidity buffer needed for potential encashment under the PRGT**. Since the inception of the ESAF, no member lending to the Trust has requested transfer of its loan claims to other lenders or sought early repayment. Most of these members were participants in the Financial Transactions Plan and generally had strong balance of payments positions. Moreover, loan contributions to the Trust by these members only represented a small fraction of their total reserve assets. It is likely that this will remain the case going forward, which suggests that a request for encashment by a lender to the PRGT is likely be a very rare event. This said, the possibility of encashment means that there needs to be a mechanism in place to handle it.

18. **At this stage, staff proposes a target for a liquidity buffer of 20 percent of outstanding loans from participating contributors**. This would be in line with the prudential balance established for GRA lending and would eventually be sufficient to cover encashment up to SDR 1.8 billion of PRGT claims (assuming that all lenders providing new

resources agree to participate in encashment). Based on current pledges, such a buffer would be sufficient to cover encashment by the largest individual lender. Provision for such a liquidity buffer would imply that total new loan commitments of about SDR 10.8 billion would need to be mobilized to meet the projected demand for concessional financing of SDR 9 billion through 2014.[11]

19. **The provision for a liquidity buffer does not imply that loan commitments would not all be used for PRGT lending**. Assuming continued lending beyond 2014 requiring additional loan resources, it is envisaged that all loan commitments to the PRGT from the current resources mobilization effort would eventually be used for their primary purpose of providing concessional loan resources as the needed liquidity buffer would be covered by new borrowing agreements. In this sense, the liquidity buffer would represent a notional amount set aside for liquidity planning purposes and replenished over time with new loan commitments as existing commitments are drawn down to finance PRGT loans. Nonetheless, it would be important to secure the additional liquidity buffer as part of the current fund-raising exercise to ensure that total PRGT lending through 2014 is not constrained below the SDR 9 billion target.

20. **Staff also considered an alternative option of using resources available in the PRGT Reserve Account as a liquidity buffer to meet possible requests for encashment**.[12] However, setting aside a portion of Reserve Account resources as a liquidity buffer would reduce the amount of security available to all PRGT lenders (both those participating in the encashment regime and those who choose not to do so). Moreover, allowing the possibility of tapping the Reserve Account for encashment would create additional uncertainty about the future self-sustained lending capacity of the PRGT. For these reasons, staff believes that it would be preferable to maintain the current role of the Reserve Account and establish the liquidity buffer as part of the new loan commitments.

B. Issuance of PRGT Notes

21. **Some lenders have indicated a preference for purchasing notes from the PRGT as an alternative to providing loans in the traditional form**. This preference could be accommodated by establishing a framework for issuing PRGT notes, taking into account the recent experience with the framework for GRA notes.[13] Under the proposed framework, the

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[11] Regular updates on the adequacy of resources in the PRGT loan accounts to meet projected loan demand and maintain a liquidity buffer would be provided as part of the regular semi-annual reviews of the Fund's concessional financing.

[12] Use of the Reserve Account for early payment of outstanding claims on the Trust would require an amendment of the PRGT Instrument adopted by an 85 percent majority of the total voting power and consent by all existing lenders.

[13] *A Framework for the Issuance of Notes to the Official Sector* (EBS/09/96, 6/17/09).

PRGT Instrument would be amended to allow for borrowing by the Trust under NPAs. This would include the authority for the Trustee to adopt general terms and conditions (GTC) for PRGT notes, with identical financial terms as loan claims. The Executive Board would endorse a form NPA as the basis for the individual NPA with specific note purchasers. The Managing Director would retain his authority under the PRGT Instrument to enter into individual loan agreements/NPAs for the benefit of the loan accounts of the Trust. Note purchasers would be encouraged to participate in encashment. A draft GTC and NPA would be provided for Board consideration, together with the proposed amendment of the PRGT Trust, following the discussion of this paper.

C. Loan Maturities

22. **Some members prefer to lend at shorter maturities than those under recent loan agreements**. There are precedents for such an approach,[14] with a key issue being the need to avoid liquidity problems that could arise from a mismatch in maturities between PRGT borrowing and Trust loans to LICs. To accommodate members' preferences while providing the necessary assurance that resources will be available for the life of the PRGT loans, the model of recent GRA borrowing could be followed. Under this model, PRGT borrowing could be structured to provide for shorter maturities of, say, one year, with the provision that the Fund, as Trustee, would have the discretion of unilaterally extending the maturity for additional periods, as needed, to match the repayment period for the underlying drawing under Trust loans (i.e., up to the maximum 10 years) and the repayment of each drawing in semi-annual installments. Under this approach, the *effective* maturity would be aligned with the repayment schedules for PRGT lending to LICs.

D. Interest Rates

23. **The expectation that a much larger portion of PRGT loans will be provided in SDRs raises the question of whether the six-month SDR rate is still appropriate as the standard interest rate for PRGT borrowing**. As discussed in Section II, the Trust has, in the past, normally paid interest to lenders semi-annually at the six-month SDR interest rate. At the inception of the ESAF in 1987, taking into account the preferences expressed by potential lenders, staff proposed two types of interest rates—a six-month variable rate (based on official rates of the SDR basket currencies) and a five-year fixed rate—for loan agreements under the Trust. In the event, among the 16 lenders, most preferred the six-month variable rate, one lender chose the five-year fixed rate, and a few others agreed to provide implicit subsidy contributions by accepting a half of one percent of interest rates. The six-month interest rate was applied to loan agreements involving lending in both currencies and SDRs.

[14] See footnote 6.

24. **Going forward, in light of the expected significantly higher level of SDR lending to the PRGT, consideration could be given to adopting a differentiated approach with respect to the interest rates paid on borrowing, depending on whether SDRs or currencies are provided**. Specifically, the PRGT could pay the three-month official SDR interest rate under loan agreements involving lending SDRs on a quarterly basis,[15] while continuing to pay the derived six-month SDR interest rate under agreements involving lending currencies on a semi-annual basis.[16] The rationale for introducing such a differentiated approach would be that the SDR interest rate reflects the direct cost for members of lending their SDRs, and the proposal would thus be essentially cost-neutral for the SDR lenders.[17]

IV. CONVERSION OF SDR LOAN RESOURCES

25. **In the context of the current fund-raising, a number of members have asked how SDRs lent to the PRGT would be treated for the purpose of the voluntary SDR trading arrangements**. In particular, some members have expressed concern that they could be expected to purchase the SDRs that are lent by other members to the PRGT. A few members have already indicated that their participation in the voluntary SDR trading arrangements should exclude SDRs lent to the PRGT, while others have been reluctant to establish voluntary trading arrangements until this matter is clarified.

26. **SDR lending to the PRGT is not new**. The PRGT Instrument and its predecessors authorize Trust borrowing in freely usable currencies or in SDRs.[18] Similarly, while PRGT loans are generally required to be disbursed in a freely usable currency as decided by the Fund, as Trustee, the Instrument also authorizes the Managing Director to make arrangements under which, at the request of a borrowing member, SDRs may be used, inter alia, for disbursements to the member (PRGT Instrument, Section II, Paragraph 4(b)). As the administrator of the SDR Department, the Fund stands ready to facilitate the conversion of Trust loan proceeds in SDRs into any useable currency requested by the borrowing member.

[15] The proposal that quarterly interest payments be the norm in SDR borrowing agreements would require an amendment of Section III, Paragraph 5(b) of the PRGT Instrument, as this provision contemplates that interest payments will be made semi-annually, in June and December.

[16] This was the approach taken in the recent borrowing agreement with the Bank of Spain, which involves lending SDRs.

[17] Historically, the differential between the 6-month and 3-month SDR interest rates has been modest, averaging at about 13 basis points in favor of the former (except during the recent crisis period). If such differences were to continue in the future, the proposed 3-month SDR interest rate for SDR loan agreements could yield a small saving for the Subsidy Accounts of the PRGT, as compared to the alternative 6-month rate.

[18] See current Section I, Paragraph 4(c) of the PRGT Instrument, which specifies that loans or donations to the Trust may also be made in or exchanged for SDRs in accordance with such arrangements as may be made by the Trust for the holding and use of SDRs.

27. **However, SDR lending to the Trust is expected to increase in size going forward**. Under the previous loan agreements, four members (China, Egypt, Italy, and Spain) committed, in aggregate, about SDR 1 billion of loan resources in SDRs over a period of nearly 20 years. Drawings of SDRs were made under these agreements and funded through transfers from these members' SDR holdings in the SDR Department. Conversion of the SDRs was handled through the voluntary trading arrangements. As already discussed, pledges for lending in SDRs under the current fund-raising exercise already amount to SDR 6 billion, and other members have expressed interest in pursuing this approach. Accordingly, it will be important to agree on how these loans will be treated.

28. **Three broad options could be considered:**

a. **Option 1:** One approach would be to require countries lending SDRs to the Trust to automatically stand ready to buy them back for currencies on request by LICs. This has the advantage of insulating the SDR holdings of other participating members under the voluntary SDR trading system from activities associated with PRGT lending. However, it is not clear whether countries would be willing to lend SDRs to the Trust under these conditions, which could undermine the effectiveness of the current fund-raising exercise. It could also discourage those countries from participating in the broader voluntary SDR trading arrangements, which would weaken the usefulness of those arrangements in supporting the market for SDRs for the benefit of all SDR holders.

b. **Option 2:** A second option would be to exclude PRGT-related SDR sales from the burden-sharing calculations used to allocate SDRs across participants in the voluntary SDR trading arrangements. This would mean that most of the SDRs lent to the PRGT would end up being transferred to other participants in the voluntary trading arrangements. As noted, several current and possible future participants in those arrangements have already indicated that such an outcome would not be acceptable to them, such that this approach does not seem feasible.

c. **Option 3:** A third option would be to continue the current practice of handling SDR conversions related to PRGT loans in the same way as other requests to sell SDRs through the informal burden sharing arrangements under the voluntary SDR trading arrangements. Under the current mechanism used by staff for allocating voluntary SDR transactions across trading arrangements, it is expected that this would lead to a situation where countries lending SDRs to the PRGT would end up buying most of the SDRs back over time. This is because, when countries extend loans to the Trust, it would lower their SDR holdings, thereby increasing the likelihood that they would be selected as counterparties for those or other SDR purchases. This would happen through the normal operation of the voluntary trading arrangements, rather than automatically or by in other ways segregating the SDR market.

29. **In staff's view, the third option should be pursued**. It would balance the urgent need to mobilize PRGT loan resources with the concerns expressed by a number of members that such loans should not be used as an indirect means of transferring SDRs to other participants in the voluntary trading arrangements. It would, therefore, appear to offer the best prospect of both raising the needed PRGT loans and maintaining broad support for the voluntary arrangements, which offer substantial benefits across the membership. It would also avoid a need to track separately those transactions that are related to SDR lending activities, which may be difficult to do in practice (for example, when LICs receiving SDRs through PRGT loans choose to convert them at a later date, or attribute a conversion request to their own SDR holdings).

30. **Also, from a practical perspective, the amounts of SDR sales from the PRGT are not expected to be large relative to the overall SDR market**. Based on the projected PRGT lending through 2014, and assuming roughly two-thirds of it involves SDRs, the maximum requests for SDR conversion associated with that lending could amount to less than SDR 1 billion per annum. This compares with the total capacity of the 28 voluntary SDR trading arrangements at present of about SDR 60 billion.[19] Also, as noted, most of this demand would be expected to fall on the countries lending SDRs to the PRGT, such that the expected requests for conversion by other members with voluntary trading arrangements would be small in practice. For this approach to work, all SDR lenders to the PRGT would need to have voluntary SDR trading arrangements in place with a capacity that is significantly larger than their expected loans to the PRGT. Staff would propose to revisit this issue after a year, to assess whether the allocation of SDR sales relating to PRGT loans has been in line with these expectations.

V. Safety of Lending to the PRGT

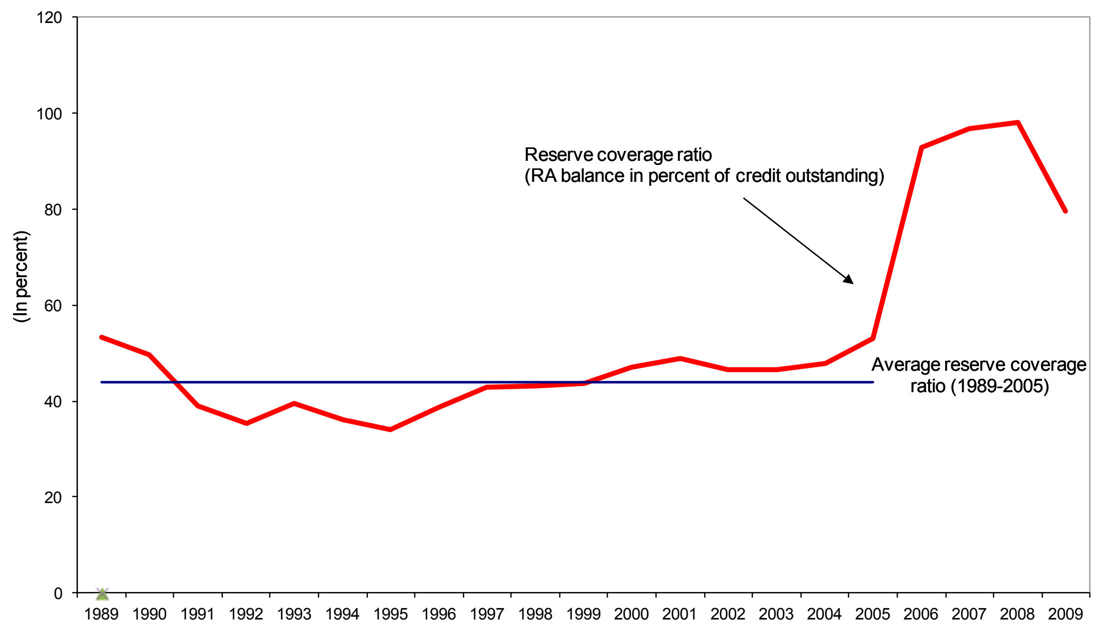
31. **Some members have stressed the continued importance of assuring the safety of lending to the PRGT and asked for further analysis of the adequacy of the PRGT Reserve Account**. The Fund, as the Trustee, maintains an excellent track record of debt service to Trust lenders. In case of late payment by LIC borrowers, the Trust can temporarily tap the resources in the Reserve Account to meet its obligations to lenders. Looking ahead, it is expected that lending to the PRGT will continue to face low credit risk. Key sources of security lie in the design and monitoring of economic adjustment and reform programs supported by the Fund, as well as country authorities' commitment to successful implementation of these programs. This is buttressed by the Fund's and, by extension, the Trust's preferred creditor status, and also supported by the historical evidence. Notably, out

[19] See *Status of Voluntary SDR Trading Arrangements and SDR Designation Plan for the Period February-April 2010* (EBS/10/12, 1/22/10) and Correction 1 (EBS/10/12, cor. 1, 1/28/10).

of 170 arrangements with LIC borrowers since the inception of the ESAF in 1987, only one country has accumulated protracted arrears to the Trust.[20]

32. **Current projections indicate that the PRGT Reserve Account will continue to provide adequate protection to PRGT lenders/note purchasers over the medium term**. The balances of the Reserve Account stood at SDR 3.9 billion at end-2009, equivalent to about 80 percent of outstanding credit from lenders. Taking into account the agreed transfer of SDR 0.62 billion (end-2008 NPV terms) under the LIC financing package, it is estimated that the remaining resources in the Account would remain sufficient to cover about 40 percent of projected outstanding credit from Trust lenders over the medium term, in line with the historical average (Figure 2).

Figure 2. PRGF-ESF Trust Reserve Account Coverage (1989-2009)

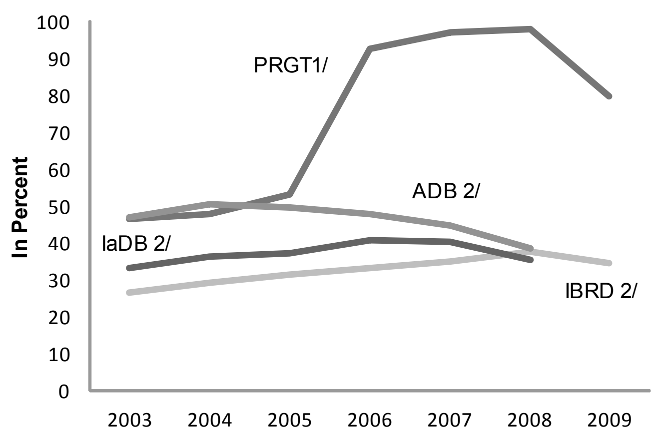


Source: Finance Department.

33. **The PRGT Reserve Account's loan coverage ratio compares also favorably with other international financial institutions**. As Figure 3 shows, in the case of the IBRD, while its equity-to-loan ratio increased in recent years, it remained at about 30 percent in 2009. The equity-to-loan ratio for both the Asian Development Bank and the Inter-American Development Bank declined in recent years, at about 40 percent and 30 percent in 2009, respectively.

[20] Since 2001, Zimbabwe has had arrears to the Trust, which now amount to SDR 89.3 million, accounting for about 2 percent of the balances of the PRGT Reserve Account.

Figure 3. Comparison of Reserve Adequacy



Source: Finance Department and MDBs.

1/ Ratio of PRGT Reserve Account balances to outstanding PRGT credit.

2/ Ratio of equity to outstanding loans.

34. **Finally, as in the case of the PRGT's predecessors, the Fund has provided further assurances to Trust lenders to address cases of late payment to them**. At the inception of the ESAF, the Board agreed that "The Fund is committed, if it appeared that any delay in payment by the trust to lenders would be protracted, to consider fully and in good faith all such initiatives as might be necessary to assure full and expeditious payment to lenders" (Decision 8759, 12/18/87). This decision continues to apply to loan resources committed by members to the PRGT, which is a successor to the ESAF Trust.

VI. Legal Requirements and Issues for Discussion

35. **Certain of the proposed approaches discussed in this paper would require amendments of the PRGT Instrument**. Such amendments would be required to: (i) allow for drawings on PRGT loan commitments to fund encashment requests; (ii) provide for the option of Trust borrowing under note purchase agreements; and (iii) authorize quarterly, rather than semi-annual, interest payments to lenders who provide SDRs to the PRGT (see footnote 15). Shorter notional maturities for PRGT borrowing and the differentiation in the interest rate between SDR and currency lending to the PRGT could be implemented on the basis of the current PRGT Instrument. The requisite Trust amendments would require a Board decision adopted by a majority of the votes cast, and consent of all existing PRGT lenders before they could become effective; the consent requirement arises because the

amendment would modify a number of "protected" provisions that can only be changed with the consent of affected contributors.[21]

36. **In light of the foregoing, Directors' views are sought on the proposed new framework for mobilizing concessional loan resources that seeks to meet the various needs and preferences of different creditors**. In particular:

- Do Directors agree that it is urgent to meet the Board endorsed fund-raising target for additional loan resources to ensure timely funding of the new LIC facilities and that SDR loans/notes are an important funding source for this purpose?

- Do Directors agree with the proposed framework for encashment to ensure that loan resources to the PRGT can qualify as reserve assets? What are Directors' views on the proposed approach to issuing PRGT notes? Do Directors agree with the staff proposals to allow for shorter notional maturities for PRGT borrowing, and to pay the three-month official SDR interest rate for loan resources in SDRs and the derived six-month SDR interest rate for borrowing in currencies?

- Do Directors view the conversion of SDR transactions arising from PRGT loans through the existing voluntary SDR trading system as a viable approach? Would they support a review of SDR trading related to the PRGT after 12 months?

- Do Directors concur that the resources in the PRGT Reserve Account provide adequate security to PRGT lenders/note purchasers?

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[21] For a more extensive discussion of protected provisions and consent requirements, see *The Multilateral Debt Relief Initiative (G-8 Proposal) and Its Implications for the Fund—Further Considerations—Supplemental Information* (SM/05/353, Sup. 1, 11/1/05, p. 11-14).