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July 1, 1996

To: Members of the Executive Board

From: The Associate Secretary

Subject: Technical Note on Effective Debt Relief Under Naples Terms

Attached for the information of Executive Directors is a technical note, prepared jointly by the staffs of the Fund and the World Bank, on effective debt relief under Naples terms. The note was requested by Executive Directors following the World Bank and Fund Executive Board discussions of the technical note on preliminary costing of the proposed framework for resolving the debt problems of the heavily indebted poor countries (SM/96/127, 6/4/96).

Mr. Brooks (ext. 38315) or Ms. Daseking (ext. 37340) is available to answer technical or factual questions relating to this note.

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INTERNATIONAL MONETARY FUND AND THE WORLD BANK

Technical Note on Effective Debt Relief Under Naples Terms

Prepared jointly by the staffs of the
International Monetary Fund and The World Bank

Approved by Thomas Leddy and Michael Bruno

June 28, 1996

As requested by Executive Directors, this note briefly describes the effective debt relief provided under Naples terms from Paris Club creditors for low-income countries. While Naples terms provide for a net present value (NPV) reduction of up to 67 percent on eligible debt, the effective NPV reduction of total debt to Paris Club creditors is typically significantly lower than 67 percent (see Box 1 for a description of Naples terms). There are two reasons for this. First, the NPV reduction applies to eligible debt only, which excludes post-cutoff date debt. 1/2/ Second, Official Development Assistance (ODA) debt is treated differently under Naples terms than non-ODA debt, which is likely to result in a NPV reduction of less than 67 percent for pre-cutoff date ODA debt. 3/

Under Naples terms, pre-cutoff date ODA debt is generally rescheduled over 40 years, with 16 years' grace, using an interest rate at least as concessional as the original interest rate. 4/ The implied NPV reduction--over and above the grant element of ODA debt before rescheduling under Naples terms--in a particular case depends on (1) the level of the interest rate applicable to the rescheduled ODA debt compared to the interest rate on the original loan and the current market interest rate, and

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1/ Debt previously rescheduled on concessional (Toronto or London) terms is subject, on a case-by-case basis, to further rescheduling to top up the amount of concessionality given earlier to 67 percent of the face value of the debt before rescheduling.

2/ On an exceptional basis, Paris Club creditors have deferred post-cutoff date arrears nonconcessionally. Creditors may tailor the extent of debt relief to a country's balance of payments need by varying the extent of coverage of debt eligible for rescheduling.

3/ A loan is classified by the OECD as ODA if it contains a grant element of at least 25 percent using a fixed 10 percent discount rate for all currencies (DAC) and is intended for development purposes.

4/ Under Naples terms, an alternative option was agreed upon by Paris Club creditors which provides for the application of a 67 percent NPV reduction to ODA debt, at the discretion of the creditor.

(2) the residual maturity of the original loan (which is a factor in determining the grant element before the stock-of-debt operation). The annex illustrates the impact of rescheduling ODA debt on Naples terms. It shows that if the interest rate applicable after rescheduling is lower than the market interest rate, a NPV reduction will be achieved, irrespective of the residual maturity period of the original loan (see upper panel, Table 1, Annex). However, if the interest rate applicable after rescheduling is the same as the interest rate on the original ODA loan, but is higher than the then prevailing market interest rate, an increase in the NPV of ODA debt would result from the extension of the maturity and grace periods under the Naples terms rescheduling, irrespective of the residual maturity of the original loan (see lower panel, Table 1, Annex). 1/

For the 13 countries for which completion costs are indicated in the costings estimates presented in the technical note on HIPC Debt Initiative costings (SM/96/127, 6/4/96; and SecM96-572, 6/4/96), the effective NPV reduction achieved by Naples terms is about 51 percent (Table 1 and Box 2). 2/ The effective NPV reduction for these countries is defined here as the cumulative NPV reduction--including the reduction achieved in earlier concessional reschedulings--in total Paris Club claims (where the value of these claims is measured before any rescheduling on concessional terms). 3/ Under the notional 90 percent NPV reduction scenario, the overall effective NPV reduction for the same group of 13 countries would be about 81 percent, including the reduction achieved in earlier concessional reschedulings (Table 1 and Box 3). It should be noted that the effective NPV reduction for a particular case would differ from the overall effective NPV reduction for the 13 countries, as it would depend in each case on the share of post-cutoff date and ODA debt (as well as the terms and residual maturity of the ODA debt).

1/ The interest rate on the original ODA loan could be above the current market interest rate, even though a grant element of 25 percent is required for debt to be classified as ODA. This is because the OECD's Development Assistance Committee (DAC) uses a discount rate of 10 percent (for all currencies) to calculate the grant element while market interest rates for most OECD currencies are currently less than 10 percent. (See also footnote 1, page 1, Annex.)

2/ Good quality data on the outstanding stock of ODA debt, the residual maturity and original interest rates for such debt are not readily available in all cases. For the purposes of the costings exercise, rough estimates of the stock of ODA debt were made in the cases where good quality data was not available. In all cases, the original grant element of ODA debt was assumed to be 50 percent and the original interest rate 2 percent (see Box 2).

3/ It should be noted that the costings exercise was based on the effective as opposed to the notional NPV reduction that would result from Paris Club rescheduling. The calculation of the effective NPV reduction was based on summing the NPV reduction--including that achieved in earlier concessional reschedulings--for the 13 countries and expressing it as a percentage of the NPV of Paris Club claims for the 13 countries (before rescheduling on concessional terms).

The effective NPV reduction under Naplès terms--including that achieved in earlier concessional reschedulings--would be 67 percent if (1) the coverage of the debt were extended to include post-cutoff date debt, and (2) pre-cutoff date ODA debt received a 67 percent reduction in the NPV of the original debt (Table 1). Including post-cutoff date debt only would result in an effective NPV reduction of 56 percent in aggregate for the 13 countries that are indicated to imply costs in the costing exercise. 1/ Alternatively, deepening the debt reduction for pre-cutoff date ODA debt to 67 percent of the NPV of the original ODA debt, rather than rescheduling it over 40 years (with 16 years' grace), would raise the effective NPV reduction to 62 percent. These calculations should in no way be taken as an endorsement of these alternative approaches, each of which would have to be evaluated on its own merits and in light of a number of other important considerations.

The above calculations of the effective NPV reduction take account of the NPV reduction already achieved on debt previously rescheduled on concessional terms, in line with the normal practice of the Paris Club. If the NPV reduction achieved in earlier concessional reschedulings were excluded from the calculations (contrary to Paris Club normal practice), the overall effective reduction in the NPV of Paris Club debt achieved solely from the stock-of-debt operation on Naples terms--defined as the NPV reduction as a percent of the NPV of outstanding Paris Club debt after earlier reschedulings on concessional (Toronto or London) terms--would be about 36 percent for the 19 countries (excluding Sudan) classified as "unsustainable" or "possibly stressed" (Table 2). An effective NPV debt reduction of 67 percent under Naples terms--excluding the NPV reduction from earlier concessional reschedulings--could only be achieved by broadening the application of the full 67 percent NPV reduction to include (1) debt previously rescheduled on concessional (Toronto or London) terms; (2) post-cutoff date debt; and (3) pre-cutoff date ODA debt. (Table 2 presents the impact for each category of debt). 2/ For the same group of countries, the effective NPV reduction achieved solely from the stock-of-debt operation on eligible Paris Club debt would be about 68 percent under the notional 90 percent NPV reduction scenario.

1/ For simplicity, no distinction was made between post-cutoff date ODA and non-ODA debt, i.e., post-cutoff date ODA debt was assumed to be rescheduled under the same terms as non-ODA debt (see Boxes 2 and 3 for the non-ODA debt rescheduling terms).

2/ These figures are presented for illustrative purposes only and not to suggest a particular means by which to achieve a higher effective level of debt reduction.

Box 1. Paris Club Naples Terms

Key elements of Naples terms, which have replaced the previous concessional (Toronto or London) terms, for low-income countries are

- **Eligibility.** Decided by creditors on a case-by-case basis, based primarily on a country's income level. Countries that have previously received concessional rescheduling (on Toronto or London terms) are eligible for Naples terms.

- **Concessionality.** Most countries receive a reduction in eligible non-ODA debt of 67 percent in net present value (NPV) terms. Some countries with a per capita income of more than $500 and a ratio of debt to exports in present value terms of less than 350 percent--decided on a case-by-case basis--receive a 50 percent NPV reduction.

- **Coverage.** The coverage (inclusion in the rescheduling agreement) of non-ODA pre-cutoff date debt is decided on a case-by-case basis in the light of balance of payments needs. Debt previously rescheduled on concessional (either Toronto or London) terms is potentially subject to further rescheduling, to top up the amount of concessionality given.[1]

- **Choice of options.** Creditors have a choice of two concessional options for achieving a 67 (or 50) percent NPV reduction,[2] namely

  a debt reduction (DR) option (repayment over 23 years with 6 years' grace), or

  a debt-service reduction (DSR) option, under which the NPV reduction is achieved by concessional interest rates (with repayment over 33 years).[3] [4]

There is also a commercial or long maturities (LM) option, providing for no NPV reduction (repayment over 40 years with 20 years' grace).[5]

- **ODA credits.** Pre-cutoff date credits are rescheduled on interest rates at least as concessional as the original interest rates over 40 years with 16 years' grace (30 years' maturity with 12 years' grace for 50 percent NPV reduction).[6]

Flow rescheduling provide for the rescheduling of debt service on eligible debt falling due during the consolidation period (generally in line with the period of the Fund arrangement).

Stock-of-debt operations, under which the entire stock of eligible pre-cutoff date debt is rescheduled concessionally, are reserved for countries with a satisfactory track record for a minimum of three years with respect to both payments under rescheduling agreements and performance under IMF arrangements. Creditors must be confident that the country will be able to respect the debt agreement as an exit rescheduling (with no further rescheduling required) and there must be a consensus among creditors to choose concessional options.

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[1]Under such topping up, the NPV reduction is increased from the original level given under Toronto or London terms to the new level agreed under Naples terms, namely 67 or 50 percent.

[2]For a 50 percent NPV reduction, the DSR option provides for repayment over 23 years with 6 years' grace and the LM option for repayment over 25 years with 16 years' grace.

[3]For flow rescheduling, there is no grace period, and for stock-of-debt operations the grace period is three years.

[4]There is, in addition, a capitalization of moratorium interest (CMI) option, which also achieves the NPV reduction by a lower interest rate over the same repayment (and grace) periods as the DSR option.

[5]Creditors choosing this option undertake best efforts to change to a concessional option at a later date when feasible.

[6]Creditors can also choose an option reducing the NPV of ODA debt by 67 (or 50) percent.

Box 2. Stylized Assumptions for Naples Terms Debt Relief from Bilateral and Commercial Creditors

In all cases, a stock-of-debt operation on Naples terms from Paris Club creditors (and comparable action by other bilateral and commercial creditors) is assumed, with debt relief to the full extent available under current mechanisms, as follows:

a. For Paris Club creditors:

(i) a NPV reduction of 67 percent for all non-ODA pre-cutoff date debt, not previously rescheduled on concessional (Toronto and London) terms.[1]

(ii) debt previously rescheduled on concessional (Toronto and London) terms is topped up to a 67 percent NPV reduction;[1]

(iii) pre-cutoff date ODA debt is rescheduled over 40 years with a grace period of 16 years, at the original interest rate (which is assumed to be 2 percent). ODA debt is assumed to have an original grant element of 50 percent.[1]

b. All non-Paris Club bilateral and commercial pre-cutoff date debt receives the full 67 percent NPV reduction, except for debt previously rescheduled with a NPV reduction of at least 67 percent for which no further NPV reduction is assumed. In the cases of Ethiopia and Nicaragua, debt to Russia is assumed to receive a NPV reduction of 90 percent, in line with the recent provisional rescheduling agreement between Nicaragua and Russia.

c. For all bilateral and commercial creditors, the grant element of non-ODA pre-cutoff date debt not previously rescheduled on concessional terms is assumed to be zero (i.e., the NPV is equal to the face value of this debt). However, if there is a significant grant element in the original debt, a lesser reduction in the NPV may result from the application of normal Paris Club practices. For instance, under the Naples terms debt reduction option the creditor agrees to forgive up to 67 percent of the face value of the debt and applies an appropriate market interest rate to the remaining 33 percent. If the original interest rate is lower than the market interest rate, and thus the original debt already includes a grant element, the NPV reduction under Naples terms would be less than 67 percent of the NPV of the original debt.

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[1]Except in the case of Cameroon, where a NPV reduction of 50 percent is assumed and ODA debt is assumed to be rescheduled over 30 years with 12 years' grace.

Box 3. Stylized Assumptions for the Purpose of Costing Enhanced Debt Relief from Bilateral and Commercial Creditors

Various assumptions for stock-of-debt operations on enhanced terms are made to simplify the estimation of the costs of the initiative, as outlined below:

a. For Paris Club creditors:

(i) a NPV reduction of up to 90 percent for all non-ODA pre-cutoff date debt, not previously rescheduled on concessional (Toronto, London and Naples) terms.

(ii) the NPV reduction on debt previously rescheduled on concessional (Toronto, London, and Naples) terms is increased to a NPV reduction of up to 90 percent.

(iii) pre-cutoff date ODA debt is assumed to have an original grant element of 50 percent, which is assumed to be increased up to 90 percent, as necessary in each case. This could be achieved by rescheduling ODA debt over longer maturity and grace periods than under Naples terms (see Box 2), and applying an interest rate at least as concessional as the original rate (which is assumed to be 2 percent).

b. All non-Paris Club bilateral and commercial pre-cutoff date debt receives the full NPV reduction of up to 90 percent. No further NPV reduction is assumed for debt previously rescheduled with a NPV reduction of at least 90 percent.. In the cases of Ethiopia and Nicaragua, debt to Russia is assumed to receive a NPV reduction of 90 percent, in line with the recent provisional rescheduling agreement between Nicaragua and Russia.

c. For all bilateral and commercial creditors, the grant element of non-ODA pre-cutoff date debt not previously rescheduled on concessional terms is assumed to be zero (as discussed in Box 2).

Some creditors have suggested a NPV reduction of up to 80 percent for official bilateral and commercial creditors under the initiative. For illustrative purposes only, the costings for a 80 percent NPV reduction scenario are included in the sensitivity analysis (Section IV), using the same assumptions on treatment of debt as outlined in this box.

Table 1. Effective Debt Reduction Achieved on Paris Club Claims for the 13 Countries Accounted for in the Costings Applying Paris Club Methodology

(In percent)

	Notional Present Value Reduction	Effective NPV Reduction 1/			
		Under current institutional arrangements 2/	If cutoff date is removed 3/ (1)	If pre-cutoff date ODA debt gets same effective debt reduction as non-ODA debt (2)	Combination of (1) and (2)
Naples terms 4/	67	51	56	62	67
Enhanced debt relief 80 percent NPV reduction 5/	80	69	75	74	80
Enhanced debt relief 90 percent NPV option 5/	90	81	88	83	90

Source: IMF and World Bank staff estimates.

1/ In line with Paris Club methodology, the effective NPV reduction is defined inclusive of the reduction achieved in earlier reschedulings on concessional (Toronto, London and Naples) terms and is expressed as a percentage of the NPV of debt before previous concessional reschedulings. The calculations are based on debt outstanding at the decision points.

2/ Assuming comprehensive coverage of pre-cutoff date debt; topping-up of debt previously rescheduled on concessional (Toronto, London, and Naples) terms; and ODA debt reduction based on the face value of ODA debt (see Boxes 2 and 3).

3/ For simplicity, no distinction is made between post-cutoff date ODA and non-ODA debt, i.e., post-cutoff date ODA debt is rescheduled on the same terms as non-ODA debt (see Boxes 2 and 3 for non-ODA debt rescheduling terms).

4/ See Box 2.

5/ See Box 3.

Table 2. Effective Debt Reduction Achieved at the Stock-of-Debt Operation on Outstanding Paris Club Debt for Countries Classified as "Unsustainable" or "Possibly Stressed" (Excluding Sudan)

(In percent)

	Notional Present Value Reduction	Effective NPV Reduction 1/				
		Under current institutional arrangements 2/	If the NPV of debt previously rescheduled on London and Toronto terms receives the notional NPV reduction (1)	If cutoff date is removed 3/ (2)	If pre-cutoff date ODA debt gets same effective debt reduction as non-ODA debt (3)	Combination of (1), (2) and (3)
Naples terms 4/	67	36	45	48	46	67
Enhanced debt relief 80 percent NPV reduction 5/	80	56	61	71	60	80
Enhanced debt relief 90 percent NPV option 5/	90	68	71	85	70	90

Source: IMF and World Bank staff estimates.

1/ Contrary to Paris Club methodology, the effective NPV reduction is defined solely as the reduction achieved at the time of the stock-of-debt operation and excludes the reduction achieved in earlier reschedulings on concessional (Toronto, London, and Naples) terms. It is expressed as a percentage of the NPV of Paris Club debt after previous concessional reschedulings. The calculations are based on debt outstanding at the decision points.

2/ Assuming comprehensive coverage of pre-cutoff date debt; topping-up of debt previously rescheduled on concessional (London, Naples, and Toronto) terms; and ODA debt reduction based on the face value of ODA debt (see Boxes 2 and 3).

3/ For simplicity, no distinction is made between post-cutoff date ODA and non-ODA debt, i.e., post-cutoff date ODA debt is rescheduled on the same terms as non-ODA debt (see Boxes 2 and 3 for non-ODA debt rescheduling terms).

4/ See Box 2.

5/ See Box 3.

Illustration of the Impact on the NPV of ODA Debt of Rescheduling on Naples Terms

This annex illustrates the impact of rescheduling on Naples terms on the NPV of ODA debt, using a simple example and alternative assumptions about (1) the interest rate on the original ODA loan and (2) the interest rate applicable to the debt after rescheduling. The NPV reduction resulting from the rescheduling also depends on the market interest rate and the residual maturity of the ODA loan. For illustrative purposes, this example assumes a market interest rate of 7 percent and a residual maturity of the ODA loan of 30 years with a grace period of 5 years.

The upper panel of Table 1 illustrates the cases where the market rate exceeds the original interest rate on the ODA loan, and hence the rate applicable after rescheduling (as, under Naples terms, ODA debt is rescheduled at an interest rate at least as concessional as the original rate). In this case, an extension of the maturity and grace period of the loan, resulting from the rescheduling on Naples terms over 40 years with 16 years' grace, lowers the NPV of the debt. For example, assuming an original interest rate of 2 percent and an interest rate after rescheduling of 2 percent would lower the NPV of the outstanding loan from 52 to 37 percent of its face value. A NPV reduction of about 29 percent of the NPV of the original loan is achieved in this case.

The middle panel of Table 1 covers the specific case where the interest rates before and after rescheduling equal the market rate. In this case, the rescheduling on Naples terms would have no impact on the NPV of the loan.

The bottom panel of Table 1 covers the cases where the interest rate after rescheduling exceeds the market rate. If, the original interest rate remains applicable after rescheduling, the NPV of the ODA loan will increase. For example, a rescheduling over 40 years with 16 years' grace at the original interest rate of 7.2 percent would increase the NPV from 102 to 103 percent of the face value of the loan. 1/ However, if the loan were rescheduled at an interest rate sufficiently below the original rate, for example 7.0 percent, the rescheduling would result in a NPV reduction from 102 to 100 percent of the loan's face value.

1/ Although the grant element of the original loan in the example is below 25 percent based on a market discount rate of 7 percent, it would nonetheless be classified as ODA, assuming it was for developmental purposes. This results from the fact that the discount rate used by the DAC of the OECD for the classification of ODA loans is fixed at 10 percent for all currencies. Based on this classification, the grant element of the original ODA claim in the example would be 26 percent, assuming an original interest rate of 7.2 percent, an original maturity of 40 years and a grace period of 15 years.

The change in the NPV of the loan as a result of the rescheduling is significantly influenced by the length of the residual maturity. This can be illustrated by using the example in the upper panel for an interest rate of 2 percent. Assuming a residual maturity of 15 years with no grace period, rather than 30 years with 5 years grace period as in Table 1, would increase the NPV of the loan before rescheduling from 52 to 72 percent of its face value. On this basis, a rescheduling on Naples terms at an interest rate of 1 percent would result in a decrease in the NPV from 72 percent to 25 percent of the face value. Therefore, the effective NPV debt reduction would be 65 percent rather than the 52 percent NPV reduction (shown in the last column of Table 1) assuming 30 years' residual maturity and 5 years' grace.

Table 1. NPV of ODA Debt Before and After Rescheduling on Naples Terms
An Illustrative Example 1/

Interest rate on rescheduled loan relative to the market and original interest rate	Original Interest Rate on ODA Loan	NPV before Rescheduling 2/ (In percent of face value)	Assumed Interest Rate on Rescheduled ODA Loan	NPV after Rescheduling 3/ (In percent of face value)	Effective NPV Debt Reduction (In percent of NPV before rescheduling)
Rescheduled rate ≤ original rate < market rate	2.0	52	1.0	25	52
	2.0	52	2.0	37	29
Rescheduled rate = original rate = market rate	7.0	100	7.0	100	--
Rescheduled rate ≤ original rate > market rate	7.2	102	7.0	100	2
	7.2	102	7.2	103	-1

1/ Assumes a market interest rate of 7 percent.

2/ Assumes a residual maturity on the original ODA loan of 30 years with 5 years grace period and a flat repayment schedule.

3/ Assumes rescheduling on Naples terms, with a maturity period of 40 years, grace period of 16 years, and graduated repayment schedule, according to Paris Club methodology.