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EBS/87/228

CONFIDENTIAL

October 29, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Enhanced Structural Adjustment Facility (SAF) - Proposed Financial Arrangements

The attached paper is tentatively scheduled for informal consideration by the Executive Board on Friday, November 13, 1987. The parts of the paper dealing with the security and liquidity of claims on the Trust (Sections III(1) and III(2)) present proposals that reflect extensive discussions in the Executive Board and with individual Executive Directors and potential lenders. The provisions suggested with respect to other aspects of the Trust's financial arrangements have not been discussed in the same detail. In light of the Executive Board's comments and guidance at the session on November 13, 1987, the staff would intend to prepare further material dealing with any outstanding issues and presenting necessary formal documentation for the Board's consideration and approval.

Mr. Leddy (ext. 8332), Mr. Boorman (ext. 7858), or Mr. Munzberg (ext. 6675) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

# Enhanced Structural Adjustment Facility (SAF)--
# Proposed Financial Arrangements

Prepared by the Treasurer's, Exchange and Trade Relations and Legal Departments

Approved by F.G. Laske, L.A. Whittome and F. Gianviti

October 29, 1987

## Contents

## I. Introduction

The principal financial characteristics of the proposed SDR 6 billion enhancement of SAF resources were outlined in an initial staff paper circulated to the Executive Board shortly after announcement of the initiative by the Managing Director and its endorsement by the participants in the Venice Summit in June 1987. 1/ A subsequent staff paper prepared in light of initial consultations with potential contributors to the proposed enhancement described, inter alia, concerns of potential lenders regarding the security and liquidity of their claims on the Trust 2/ that had been proposed for the mobilization of resources for the SAF enhancement. It also outlined a series of steps that could be taken to provide protection for the security of, and liquidity for, those claims. 3/ The latter paper was considered by the Executive Board at EBM/87/138, at which the concept of a Trust for the SAF enhancement was endorsed by a large majority of Directors, and these matters have been the subject of further discussions between the staff and potential lenders.

Taking into account the comments and suggestions of Executive Directors and potential lenders on the papers mentioned above, this memorandum presents specific proposals for financial arrangements to be established in connection with the proposed Trust. (Discussions are continuing with a very few lenders that are considering the provision of bilateral loans in parallel with loans by the Trust.) Section II provides a summary of the principal financial terms proposed for loans to be extended by the Trust, which are essential determinants of the nature of the financing that must be obtained by the Trust for the purposes of the SAF enhancement. Section III deals with arrangements relating to lending to the proposed Trust. Section IV discusses the operations of the proposed Subsidy Account, and Section V presents a summary of proposals. A companion paper, dealing with questions of access and program monitoring in connection with the use of resources under the SAF enhancement, and which also has a bearing on certain aspects of the financial arrangements discussed in the present paper, will be issued shortly. Draft decisions, instruments, and prototypes of borrowing agreements that would be necessary in order to give effect to the proposed enhancement will also be circulated for consideration by the Executive Board.

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1/ See "Mobilization of Resources in Association with the Structural Adjustment Facility--Financial Arrangements" (EBS/87/129, 6/12/87).

2/ Unless indicated otherwise, all references in this paper to the "Trust" are to the Trust proposed for administration of the SAF enhancement.

3/ See "Further Considerations on the Mobilization of Resources in Association with the Structural Adjustment Facility (SAF)" (EBS/87/190, 9/2/87).

## II. Principal Financial Conditions of Loans by the Trust

It is envisaged that enhanced SAF loans extended by the proposed Trust will be subject, insofar as possible, to the same financial terms and conditions as those applying to SAF loans. The main terms and conditions proposed, which would be specified in the Trust instrument, are summarized below.

1. Commitments. The Trust's loan commitments would be made in support of three-year adjustment programs adopted by SAF borrowers. Commitments and disbursements would be subject to the availability of funds to the Trust.

2. Maturity. Loans extended by the Trust would be repayable in 10 equal semi-annual installments beginning 5 1/2 and ending 10 years after the date of each disbursement.

3. Interest. An objective of the SAF enhancement is to obtain financing, including subsidy donations, on terms that enable interest to be charged by the Trust at the highly concessional rate charged under the SAF itself, i.e., 0.5 percent per annum, or as close as possible thereto. This matter is discussed in Section IV. Interest on loans extended by the Trust would be payable on June 30 and December 31 of each year, as under the SAF.

It is proposed that any overdue repayment obligations to the Trust would no longer be subject to subsidization. Therefore, interest on overdue repayment obligations to the Trust would accrue at the cost of funds to the Trust during the relevant interest periods. Moreover, as a borrower's failure to make timely payment of interest to the Trust would effectively reduce the Trust's Reserve and investment earnings thereon (see Section III(1) below), it is proposed that interest also accrue on unpaid interest at the cost of funds to the Trust during the relevant interest periods.

4. Denomination. It is proposed that the SDR be the unit of account for all operations by the Trust, including borrowers' obligations with respect to loans from the Trust, as under the SAF.

5. Media. The media used in disbursement of loans by the Trust will be determined by the media of loans available to the Trust for that purpose. It is proposed below that drawings on loans to the Trust be in the form of freely usable currencies or under arrangements for conversion into freely usable currencies or SDRs. It is proposed that payments by borrowers of their obligations to the Trust be made in U.S. dollars.

## III. Borrowing Operations of the Trust

Loans by the Trust to SAF-eligible countries will be financed by borrowing by the Fund, as Trustee, under a series of agreements with individual lenders. Lenders' commitments to make funds available to the Trust will need to cover the period agreed for disbursements to SAF borrowers (discussed briefly below and in greater detail in the forthcoming paper on the Trust's lending policies), and the maturities of individual calls on loans to the Trust will need to cover at least the 5 1/2-10 year maturities of the Trust's loans to SAF borrowers. It is anticipated that there will need to be variations among the individual agreements for lending to the Trust to reflect particular legal and institutional requirements or preferences of the lenders. It is expected that some lenders will provide funding through loans of reserves by monetary authorities, which will be likely to have certain implications for the provisions relating to maturities, interest, and liquidity of claims, while others will extend financing from other sources through other governmental entities. Regardless of the source and nature of the financing provided, however, it is important that the agreements be comparable in substance as regards the principal financial provisions relating to commitments, repayment terms, denomination, and exposure to any risk of late payments. As regards interest rates on loans to the Trust, a variety of possibilities is envisaged, as discussed below.

This section first discusses the arrangements proposed with respect to the security and liquidity of claims on the Trust, which have been of primary interest to many potential lenders. It then addresses other financial aspects of the Trust's operations and borrowing agreements between lenders and the Trust.

### 1. Security of claims on the Trust

As stressed in EBS/87/190, the most important underlying assurances of repayment to lenders will be provided by the quality of the adjustment programs financed by the Trust. Nonetheless, a risk of nonpayment would remain, and most if not all potential lenders have placed emphasis on the provision of security against this risk beyond the security inherent in borrowers' adjustment programs. 1/ EBS/87/190 listed a number of techniques and sources for providing additional security, as a basis for preliminary discussions by the Executive Board and with potential lenders. In light of these preliminary discussions, it is proposed that the following elements of security be provided for claims on the Trust.

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1/ Lenders' claims would be on the Trust, and not on individual borrowers from the Trust. Any risk would thus be "pooled" across the total of the Trust's loan operations.

a. A Reserve would be established in the Trust. This Reserve would be drawn upon if and as necessary, in the event of delays in payments by the Trust's borrowers, up to the full amount available, to meet obligations of the Trust to make repayment of or pay interest on loans to the Trust as they fall due. The Reserve would be financed from the following sources.

(i) All earnings on the investment of funds held in the Special Disbursement Account (SDA) pending disbursement under SAF loans. Such earnings currently amount to SDR 85 million and are roughly projected to accumulate to about SDR 150 million by end-1990, when it is assumed that most or all of SAF resources will have been disbursed.

(ii) All receipts of interest on SAF loans. Such receipts are projected to amount to about SDR 100 million over the life of the Trust.

(iii) All repayments on SAF loans. Repayments will begin in February 1992 and are projected to accumulate to SDR 2.7 billion by the year 2000.

(iv) Any interest and principal on loans extended by the 1976 Trust Fund and paid to the SDA following the termination of SAF lending.

(v) Any net income arising from the investment of balances held by the Trust outside the Reserve (e.g., as a result of transfers to the Trust of funds in advance of their disbursement to borrowers or payment to lenders). Any such incidental income could be available for reimbursement for the Fund's administrative expenses. 1/

(vi) All earnings on the investment of the elements of the reserve listed in (i)-(v) above.

The establishment of such a Reserve in the Trust would provide a visible and concrete source of security and would go beyond, and therefore obviate the need for, subordination of SAF claims or provision of "assurances" by the SDA, suggested as possible alternatives in EBS/87/190. While certain other sources of funding for the proposed Reserve were put forward for consideration, these did not find general support in the Executive Board's earlier discussions and are not considered further in this paper.

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1/ It is proposed below that the Fund's expenses in administering the Trust be reimbursed by the SDA, as are the expenses of administering the SAF. Coverage of these expenses could reduce slightly transfers to the Reserve.

Together, the sources of funding for the Reserve proposed above are projected to accumulate to roughly SDR 4.8 billion over the life of the Trust, on the basis of current projections of SAF disbursements, the present rates of return on investments, and the assumption that members' obligations to the SAF are paid on time. Table 1 illustrates the time path of the projected accumulation of balances in the Reserve. As mentioned in EBS/87/190, the amounts to be placed to the Reserve from these sources would be very large in relation to the total obligations of the Trust. The Reserve could provide greater coverage against risk of nonpayment of the Trust's obligations in the event, as expected, that some lenders contribute to the SAF enhancement through parallel bilateral lending.

Table 1. Projections of Proposed Reserve and Obligations of the Trust

(In SDR millions)

| | Proposed Reserve | | | |
|---|---|---|---|---|
| | Transfers from SDA | Investment earnings 1/ | Cumulative total (end of year) | Trust obligations 2/ (end of year) |
| 1988 | 148 3/ | 10 | 157 | 1,333 |
| 1989 | 34 | 13 | 204 | 2,667 |
| 1990 | 22 | 16 | 242 | 4,000 |
| 1991 | 14 | 18 | 274 | 5,334 |
| 1992 | 46 | 22 | 342 | 6,000 |
| 1993 | 172 | 33 | 546 | 5,933 |
| 1994 | 331 | 56 | 933 | 5,600 |
| 1995 | 463 | 91 | 1,487 | 5,000 |
| 1996 | 540 | 134 | 2,161 | 4,133 |
| 1997 | 518 | 182 | 2,860 | 3,000 |
| 1998 | 390 | 225 | 3,475 | 1,867 |
| 1999 | 228 | 260 | 3,964 | 1,000 |
| 2000 | 93 | 288 | 4,344 | 400 |
| 2001 | 14 | 310 | 4,669 | 67 |
| 2002 (First half) | -- | 163 | 4,832 | -- |

Note: Details may not add to totals due to rounding.
1/ At assumed interest rate of 7 percent.
2/ Repayment obligations outstanding.
3/ Includes transfer of all past investment earnings and receipts of interest on SAF loans in the Special Disbursement Account.

Potential lenders have pointed out that a large part of the proposed Reserve would itself be subject to risk of nonpayment, as it derives from payments on SAF loans. This is so, but it is also true that to sustain a hypothesis that the Reserve could become insufficient, it would be necessary to assume far greater rates of nonpayment of both SAF obligations and enhanced SAF obligations than could reasonably be anticipated on the basis of the Fund's experience to date. As discussed in the Appendix to this paper, the Reserve would be more than sufficient to cover all the Trust's remaining obligations even on the assumption that borrowers failed to make payment of some 40 percent of their obligations to the Trust and some 25 percent of their obligations to the SAF (and assuming also that the entire SDR 6 billion in enhanced SAF lending were channeled through the Trust). 1/ Such failures with respect to Fund-related obligations would be unprecedented and could occur only in the context of deep and widespread world economic problems, a situation in which the quality of a wide range of claims would be open to doubt. Thus, while it cannot be guaranteed that the proposed Reserve would provide absolute protection against risk of nonpayment of enhanced SAF loans in all contingencies, the Reserve in all likelihood would provide adequate security in any conditions that could realistically be anticipated.

Among other elements of the Trust's operations, developments in the Trust's Reserve and the situation with respect to any overdue obligations to the Trust would be subject to regular review. As is evident from the figures in Table 1, it is projected that the amounts actually held in the Reserve would begin to exceed the remaining obligations of the Trust around early 1998. At that point, the Fund could consider a number of options regarding the disposition of excess amounts available to the Reserve. These could include, inter alia, use of some part of the available funds in payment of subsidies on remaining outstanding balances of enhanced SAF loans in the event the amounts available to the Subsidy Account prove to be insufficient at that time. 2/

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1/ As explained in the Appendix, it has been assumed in making simulations regarding nonpayment that borrowers' access to the Trust would be differentiated in terms of quotas while access to the existing SAF is not. A borrower's failure to pay its obligations both to the Trust and to the SAF could thus result in different proportions of nonpayment for the two accounts.

2/ The operations of the subsidy mechanism, and uncertainties regarding the adequacy of subsidy contributions over the life of the Trust's operations, are discussed in Section IV.

The purpose of transfers from the SDA to the Reserve will be stated clearly in the decision on those transfers. The decision could also specify the future use of the amounts no longer needed for the original purposes. A decision to terminate use for the Reserve and to retransfer these resources to the SDA would require a simple majority of the votes cast. This decision could be part of the original transfer decision, the retransfer being triggered automatically by specified

Funding of the Reserve from the sources proposed above would involve use of resources of the Special Disbursement Account. Decisions regarding such use will require approval by an 85 percent majority of the total voting power of the Fund. Specifically, it would have to be decided that the following resources, which are or will become part of the SDA, will be transferred to the Reserve of the Trust. 1/

(i) The income from investment of resources available for disbursement under the SAF that has already accrued or that will accrue; and interest on loans under the SAF that has already accrued or that will accrue. (Under Decision No. 8237-(86/56) SAF, adopted March 26, 1986, receipts from these sources accruing to the SDA during the period December 17, 1980 to June 30, 1991 are available to the SAF.)

(ii) Repayments of loans under the SAF as they accrue. The repayments would be made to the SDA in order to discharge the obligation under the SAF, and would be transferred by the Fund to the Reserve upon receipt.

(iii) Repayments of loans and interest on loans extended under the 1976 Trust Fund, which are to become part of the SDA in accordance with Decision No. 6704-(80/185) TR, adopted December 17, 1980, but which are received following the termination of SAF lending.

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2/ (Cont'd from p. 6) circumstances, or it could be taken later. If it were intended to use the resources for other purposes, e.g., payment of subsidies, such a decision would require an 85 percent majority of the total voting power and could be adopted either now or at a later date. This decision would imply a change of use; while placement to the Reserve is a possibly temporary transfer from the SDA and the SDA would in any event ultimately hold a claim on the borrower in the case of a payment from the Reserve, the use of SDA resources for subsidy payments would involve a permanent depletion of the resources of the SDA.

1/ These transfers to the Reserve would be in accordance with Article V, Section 12(f)(ii). The transfers would be an operation for the benefit of developing countries that are eligible to receive resources from the enhanced SAF. In case of a failure by those countries to repay the Trust, the resources in the Reserve would be used to repay the creditors of the Trust. Such payment by the Reserve would not discharge the outstanding obligations of the debtors. In effect, there would be a temporary financing by the Reserve of those obligations, which would remain payable. Since the resources transferred to the Reserve would otherwise be available for use under the SAF (or for any other uses permitted under the SDA), the transfer to the Reserve changes or establishes the use of the resources, and therefore requires a decision by an 85 percent majority of the total voting power (Article V, Section 12(f)(last sentence)).

b. Notwithstanding the added security that would be provided by the proposed Reserve, some residual risk of nonpayment of the Trust's obligations would remain, at least in theory. In recognition of this residual risk, the Fund could commit itself, if it appeared that any delay in payment by the Trust would be protracted, to consider fully and in good faith all such initiatives as might be necessary to assure full payment to lenders. Some potential lenders have suggested that the remedial action to be considered by the Fund in such a situation be specified as the sale of gold by the Fund and use of the proceeds in excess of SDR 35 per ounce to satisfy the Trust's obligations. While such sales are obviously a possibility that is covered by the reference to "all such initiatives," they would certainly not be the only course open to the Fund, nor necessarily the preferable one in the circumstances prevailing at the time. It is not possible to know in advance the extent of any residual Trust obligations, nor what possible range of initiatives might be preferable to the Fund at that time. It has been explained in the previous paper on modalities that, under the Articles of Agreement, direct compensation for the Trust could not come from the General Resources Account. However, other possibilities could include, for example, borrowing by the Fund as Trustee or the provision of the Fund's general resources to a SAF borrower, under adequate safeguards and in full consistency with the Fund's policies and the requirements of uniformity, in a manner that assured their use to meet the borrower's obligations to the Trust. It is the strong view of management that, considering that any amount of a possible residual obligation could only be very small, use of gold, while not ruled out, might well not be the preferred course of action.

2. Liquidity of claims on the Trust

As noted, it is expected that a number of lenders will provide financing through loans of reserves by their monetary authorities. Several such potential lenders have expressed particular concern that their claims on the Trust have an appropriate degree of liquidity, and have indicated preparedness to participate in arrangements under which lenders would undertake mutually to help assure the liquidity of claims. In contrast, some other potential lenders have indicated that, given the nature of the financing they will be using, liquidity of claims is not of prime importance to them, and that they would not be in a position to enter into mutual arrangements for the provision of liquidity.

In light of these and other views and considerations on this matter, the following provisions are proposed with respect to the liquidity of claims on the Trust. Related questions concerning the maturities of drawings on loans to the Trust are discussed in Section 5 below.

a. Any claim on the Trust would be transferable to other lenders, Fund members, or other official entities on a voluntary basis, and subject to such terms and conditions as may be agreed between the transferees at the time of the transfer. However, any obligation of the transferor of a claim with respect to renewal of that claim would have to be assumed by the transferee (see discussion of maturities below). Upon request, the Fund would be prepared to assist in arranging transfers under this provision, which would be open to any holder of claims on the Trust.

b. For those lenders so electing at the outset ("electing lenders"), the following additional provisions would apply.

(i) Calls on a lender's commitment could be suspended <u>temporarily</u>, upon a representation by the lender of a liquidity need for such suspension and a finding by the Fund, having given the overwhelming benefit of any doubt to the representation, that suspension is justified. Such a representation would not be expected to be made by any lender whose currency was currently usable in transfers under the Fund's operational budget. It would not be intended that such suspensions lead to withdrawal (or partial withdrawal) by a lender from participation in the SAF enhancement, which would effectively reduce the amounts available to the Trust and imply a shift in relative participation among lenders. Therefore, it is proposed that provision be made for termination of any suspension within a short period, say, three months, subject to extension by agreement with the Fund within limits designed to permit full utilization of the lender's commitment prior to termination of the drawdown period. (A suspension of calls on a lender would imply that disproportionately heavy calls would be made on other lenders during the period of the suspension. Following termination of a suspension, subsequent calls would be arranged so as to restore broad proportionality in the use of lenders' commitments, discussed further below.) In the event the lender's liquidity need persisted, it would be open to it to avail itself of the provisions below.

(ii) Each "electing lender" would undertake to purchase, within certain limits and on a reversible basis, the claims of other "electing lenders" representing a liquidity need to mobilize their claims on the Trust, and subject to a determination by the Fund as under (i) above. 1/ Transfers under this provision would take the form of three-month swaps of the claims, at face value, for freely usable currency. Interest on the claim would continue to accrue to the original lender at the rate specified in its loan agreement, and interest on the swap would be paid by the transferor at the SDR interest rate (i.e., currently the three-month combined domestic rate). Up to, say, three

1/ As also noted with respect to the transfer provision described under (a) above, the transferee would have to assume any obligation of the transferor with respect to renewal of the transferred claim until the transfer was reversed.

renewals would be possible on the same basis at the option of the transferor, subject to a determination by the Fund regarding continuing justification and to a requirement that the transfer be reversed not later than the final maturity date of the claim transferred. This latter provision would be intended provide assurance that a lender accepting claims in transfers under this provision would not also accept exposure to any residual risk of late payment by the Trust that might be associated with the claim.

Such mutual undertakings would need to be limited and shared in an agreed fashion. If the acceptance of a claim under this provision were to be counted against the transferee's loan commitment to the Trust, the amounts effectively available to the Trust would be reduced by the amount of such transfers outstanding at any time. Moreover, if "electing lenders'" undertakings to accept claims in such transfers were limited to and within their loan commitments to the Trust, such arrangements could provide a source of liquidity for claims on the Trust only for a relatively brief time, i.e., only until commitments had been fully drawn. It appears necessary, therefore, that such undertakings be separate from lenders' loan commitments, though distributed in proportion to the loan commitments of those lenders electing to utilize this provision.

At this time, uncertainties remain about the number of lenders that may wish to participate in such mutual liquidity arrangements and about the amounts of their loan commitments. On a tentative basis, it is suggested that each such lender might undertake to acquire claims under this provision only to the extent that the claims so acquired and held at any time would not exceed an amount equivalent to (but separate from) its lending commitment to the Trust. Transfers under this provision would be distributed in proportion to "electing lenders'" undertakings to accept transfers, subject to provision for such a lender to request exclusion from a particular transfer on the basis of liquidity need and a determination by the Fund that such request is justified.

(c) The Fund's resources could provide additional protection in the event a member needed to draw on them because of temporary liquidity developments. Under Article V, Section 3(b)(ii), a member is entitled to purchase from the General Resources Account "if it represents that it has a need to make the purchase because of its balance of payments or its reserve position or developments in its reserves." As explained in the Commentary on the Second Amendment of the Articles of Agreement, "under the concept of need in Article V, Section 3(b)(ii), a member will be able to purchase the currencies of other members from the Fund if its balance of payments position or its reserve position is unfavorable, or if there is an unfavorable development in its reserves, e.g., because of an impending discharge of liabilities, even though it does not have a deficit in its balance of payments according to accepted definitions of the balance of payments." Liquidity developments in the member's reserves, therefore, can provide a justification for such a purchase. As for any use of the Fund's general resources, adequate safeguards for the temporary use of these resources must be provided by the member (Article I, Section (v)). The adequacy of these safeguards would have to be judged on a case-by-case basis. The assessment would be related to the dimensions of the member's liquidity problem and the time considered necessary for a reversal of that problem. Depending on the circumstances, the claim on the Trust could be taken into account as a safeguard for the Fund.

Utilization of the Fund's general resources under this provision would be subject to the Fund's then-applicable policies regarding use of its resources, access, charges, and repurchase. It would be expected, in accordance with Article V, Section 7(b) (first sentence), that the member would repurchase as soon as permitted by subsequent developments in its balance of payments and reserves. 1/ It would also be assumed that the member would use any available reserve tranche position in the Fund prior to making a request under this provision.

d. The staff has given further consideration to the question whether the Trust could appropriately use part of the Reserve to meet requests for encashment of claims. As shown in Table 1, it is projected that the Reserve will not begin to build toward substantial amounts until around the mid-1990s, and the Reserve therefore could not begin to provide a major source of liquidity until that time. Moreover, any use of the Reserve to finance encashments by one or more lenders would impair its ability to provide assurances to all lenders against the risk of late payments by the Trust, in particular as the Trust's repayment obligations would also begin to rise at about the same time. At a later stage, as noted above, it would be expected that the amounts potentially available to the Reserve would begin to exceed the Trust's obligations. It would be possible at that point to consider whether some "excess" Reserve should be accumulated and kept available to meet requests for encashment of claims, but it does not seem desirable or feasible to provide for such encashments through use of the Reserve at the outset.

3. Loan commitments to the Trust

a. Commitment periods. It has been envisaged that lending under the SAF enhancement would be concentrated in the three-year period 1988-90. However, as noted in EBS/87/190, the period over which disbursements will be made by the Trust, and thus the period over which funding provided by lenders' commitments will have to remain available, will depend in part on any cutoff date that may be established for borrowers to qualify for loans from the Trust and on the timing and

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1/ The Fund may also adopt policies requiring early repurchase, after consultation with the member, when the member's balance of payments and reserve position has improved (Article V, Section 7(b), second sentence). These policies, to be adopted by a majority of votes cast, could specify particular circumstances of the improvement, e.g., the reversal of the liquidity shortage upon repayment or sale of the claim on the Trust.

phasing of disbursements in support of their three-year adjustment programs. 1/ For example, if it were assumed that the Trust's operations begin on January 1, 1988, that borrowers could qualify for loans at any time during a period of, say, 1 1/2 years, and that the loans would be disbursed in full not later than three years after program approval, the overall disbursement period, and thus the period during which lenders' commitments would need to remain available, would run about 4 1/2 years to mid-1992. It is possible that some lenders' commitments will become available for use only after some delay. Actual demands for the Trust's resources might permit or require the full drawdown of available funds from other lenders well before the final disbursement date; financing of later disbursements (within the agreed overall disbursement period) would then be concentrated on the delayed commitments. However, there is no certainty regarding the timing of demands within any final cutoff date that may be established for qualification for loans from the Trust and, as discussed further below, the staff would propose to distribute calls among all lenders on a broadly proportionate basis.

It is proposed, therefore, that the commitments of all lenders, i.e., the period during which the Trust could make calls on those commitments, run to a common date, which would be established, with the agreement of the lenders, in light of the Executive Board's consideration of the issues noted above and specified in each loan agreement.

b. Limitations on drawings. A further question is whether there could be constraints on the timing of drawdowns on the commitments of individual lenders. As noted, it has been envisaged that lending by the Trust would be concentrated over the three years 1988-90. The question has been raised whether lenders' commitments could be uniformly structured to permit drawings of, say, one third of each commitment in each of the years 1988, 1989 and 1990. Some greater flexibility will be needed for several reasons. First, as noted above, it is likely that there will be a need for lenders' commitments to remain available for use beyond 1990. Second, within the overall disbursement period, to be established, it is not possible to predict exactly what the Trust's disbursement requirements will be in any given year. Third, the likelihood of the delayed availability of some loan commitments would imply disproportionately heavy use, temporarily, of those commitments that do become available in the earlier stages. At the same time, some lenders may face internal legal or financial constraints on amounts that can be made available by particular dates; even in the absence of such constraints, some may not be prepared to permit unlimited use of their credit lines (within the total amount committed) in the interim until other lenders' credit lines become available for use.

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1/ These matters are discussed in the forthcoming paper on the Trust's lending policies.

On balance, it would seem reasonable for the Trust to accept certain limitations on the rate at which commitments can be drawn, if a lender considers such limitations to be necessary. Taking into account the various uncertainties, it is suggested that the Trust be prepared, at an individual lender's request, to accept limitations such that drawings on its commitment could not exceed one third of the total until January 1, 1989 and two thirds of the total until January 1, 1990. 1/

4. Procedures for calls on loans to the Trust

It is proposed that lenders' commitments to the Trust take the form of lines of credit which could be drawn upon to finance the Trust's loan disbursements to borrowers on a same-day, pass-through basis. This would avoid the need for investment of funds by the Trust pending disbursement (which could give rise to net costs depending on rates of interest on loans and returns on investments) and the associated loss of effective maturity that could be entailed in drawings in advance of disbursement. 2/

a. Also in order to avoid such effects on costs and maturities, it is proposed that calls be initiated only after approval of borrowers' arrangements (or any other elements requiring satisfaction for a disbursement) by the Executive Board. This would avoid the possibility that calls would be initiated to finance anticipated loan disbursements that did not actually materialize.

b. In order to maintain a close link between any necessary approvals and disbursement of funds, it is proposed that the period for notice of calls on lenders be relatively short--i.e., five business days of the Fund prior to the value date of the call.

c. Given the large number of potential lenders, and also the prospect that not all loan commitments may become available for use at the same time, it is not expected that calls would be made on all lenders in connection with the financing of each disbursement by the Trust. Some flexibility in this regard would permit avoidance of undue fragmentation of calls and minimize the need for large numbers of small transactions and the associated administrative costs for lenders, borrowers, and the Fund in administering the Trust.

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1/ It is noted that the Trust's commitments to make disbursements will need in any case to be subject to the availability of funds.

2/ Should some lenders prefer to provide funds to the Trust on a different basis, e.g., in three annual installments, it would be necessary to incorporate arrangements that would assure that the funds would remain available over the full duration of the 5 1/2-10 year maturities of the SAF loans financed, and that interest charged on the proceeds of loans held by the Trust pending disbursement did not exceed the Trust's investment earnings on those balances.

However, as under the Fund's operational budgets and designation plans, the staff would intend to arrange calls in connection with successive disbursements so as to maintain broad proportionality in the use of lenders' commitments over time. This would be intended to assure participation in the actual provision of financing in broad proportion to commitments, and thereby also to facilitate an equitable distribution of exposure to any residual risks of late payments by the Trust. With respect to loan commitments that may become available for use only after some delay, priority would be given to calls on those commitments in order to restore broad proportionality among lenders within a reasonable period, and the staff would seek to manage calls so as to assure fully proportionate use at the time calls were terminated.

d. Calls on lenders to the Trust would take account of amounts of financing to be provided separately in the form of parallel bilateral loans. In managing the total funds available for the SAF enhancement, it would be intended to maintain broad proportionality over time in use of parallel and Trust financing. However, as with respect to calls on loans to the Trust itself, this would not necessarily imply that financing would be made available by bilateral lenders in connection with each operation.

e. Some administrative savings would be possible if disbursements could be combined and made, say, on two occasions each month, as is the practice with disbursements of borrowed resources by the Fund under the enlarged access policy. Although such an approach could imply some delays in disbursements following necessary approvals, these would not be expected to exceed one week on average; the approach would facilitate the combining of calls on individual lenders, reduction in the number of separate operations required, and a consequent saving in administrative expenses.

5. Maturity of loans to the Trust

It is proposed that loans extended by the Trust be repayable on the same basis as loans by the SAF--i.e., in 10 equal semi-annual installments beginning 5 1/2 years and ending 10 years after the date of disbursement. It is essential that the financing made available by lenders to the Trust effectively accommodate these maturities: the Trust would have little capacity to make repayment in the short term and might not be in a position to repay loans extended on intermediate maturities, despite the projected build-up of the proposed Reserve. Moreover, even if the Reserve were sufficient to make repayment of loans extended for periods shorter than those proposed, such use of the Reserve would erode the security of the claims of other lenders, in effect placing the claims of shorter-term lenders in preferred status.

The staff understands that a number of lenders will likely be in a position without difficulty to extend loans with maturities of 5 1/2 to 10 years, effectively matching the maturities of loans by the Trust. However, some other lenders, notably those expecting to provide loans of reserves through their monetary authorities, may face limitations of a formal and legal nature on the maturity of any disposition of those reserves. It would be possible for the Trust to accommodate such formal limitations, for example through use of short-term drawings (say, six months), subject to renewals up to the intended 5 1/2-10 year final maturities. However, it would need to be understood clearly that such renewals would be requested by the Fund as Trustee and would in practice be agreed by the lenders.

Precise formulations may need to be tailored to the requirements of individual lenders. However, the staff would propose that such arrangements contain the following elements, which would be intended to meet lenders' formal requirements while preserving the financial base of the Trust over its full term and facilitating the maintenance of proportionality in participation and exposure to any residual risk among lenders: (i) that the lender will consider sympathetically and is expected to agree to requests for renewal by the Fund, up to the final maturity; and (ii) that if, notwithstanding this expectation, the lender is unable to agree to a requested renewal and the Trust makes repayment, the lender is committed to extend a new loan to the Trust in, say, six months' time, in the amount of the renewal in question and subject to the terms that would have applied had the renewal been agreed. 1/ Such undertakings would need to be accepted also by any transferee acquiring claims subject to such provisions.

6. Interest on loans to the Trust

It is anticipated that different lenders will wish to provide their loans on differing interest rate terms, in part as a result of the varying institutional arrangements being contemplated. Some potential lenders have indicated that they will provide loans at an interest rate of 0.5 percent per annum, directly matching the rate intended for loans by the Trust. Others have indicated that they envisage loans at "market" rates, while still others may be considering loans at concessional rates, though not as low as 0.5 percent. Although these matters have not been discussed in detail, the staff expects that some lenders (notably those providing loans of reserves) may prefer floating short-term rates, matching the drawing and renewal periods of their loans; others may prefer longer-term fixed rates to be established either for all calls under their commitments or in relation to rates prevailing at the time of each call.

The possibility of a multiplicity of interest rates and interest rate bases raises complications for the operations of the Subsidy Account which are discussed further in Section IV. In discussions with

1/ The Trust's ability to make repayment if a renewal were not agreed would be dependent on the position of the Reserve at the time, and repayment would deplete the Reserve. The new loan would, in effect, restore the Reserve.

individual lenders, the staff has asked them to consider either providing their own loans to the Trust at 0.5 percent (thus including the desired subsidy directly in the interest rate on the loan) or undertaking to provide donations, via the Subsidy Account, fully sufficient to achieve the same result. Either approach would help to reduce uncertainties about the Trust's ability to provide loans to SAF borrowers at an effective interest rate of 0.5 percent.

To the extent that lenders intend to provide loans to the Trust at market-related rates, the following rates are proposed in light of the purposes of the SAF enhancement and the desirability of minimizing costs to borrowers, and to help facilitate equitable treatment among lenders.

(i) For those providing short-term renewable drawings and desiring floating rates, SDR combined domestic rates for six-month maturities (i.e., the period suggested above for drawings and renewals), the rate to be adjusted on the basis of rates prevailing at the time of each renewal.

(ii) For those desiring fixed rates for each call, the SDR combined domestic rate for five-year maturities, the rate to be established at the time of the call. 1/

(iii) For those desiring a fixed rate for all calls under their loan commitments, the SDR combined domestic rate for five-year maturities prevailing on the date their loan commitment becomes effective. 1/

Both the six-month and five-year domestic combined rates are available to and computed regularly by the Fund on the basis of information provided by reporting agencies in the five countries whose currencies are included in the SDR basket, and have been utilized extensively in the Fund's borrowing arrangements in the past. Rates closer to the average maturity of loans to the Trust are not currently available for all of the basket currencies. For reference, series for both the six-month and five-year rates are shown in Table 2.

It is proposed that interest be paid by the Trust to lenders semiannually, to coincide as closely as possible with the interest payment dates on loans extended by the Trust. Accordingly, interest would be payable by the Trust on outstanding loan balances as soon as the required computations can be made following June 30 and December 31.

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1/ Depending on the funding arrangements made for participants' loans and subsidy contributions, it might be desirable to provide for an adjustment in the event of a substantial fall in market interest rates during the Trust's operations, which could reduce the subsidy payments required of the donor agency.

Table 2. Combined SDR Domestic Interest Rates 1/

(In percent)

| | | Six-month | Five-year |
|---|---|---|---|
| 1982 | | 11.05 | 11.96 |
| 1983 | | 8.74 | 10.27 |
| 1984 | | 9.30 | 10.80 |
| 1985 | | 8.00 | 9.30 |
| 1986 | | 6.45 | 7.11 |
| 1987 | | | |
| January | | 6.11 | 6.82 |
| February | | 6.05 | 6.75 |
| March | | 5.88 | 6.50 |
| April | | 5.92 | 6.67 |
| May | | 5.85 | 6.88 |
| June | | 5.88 | 6.91 |
| July | | 5.90 | 7.16 |
| August | | 6.20 | 7.47 |
| September | 2 | 6.38 | 7.69 |
| | 9 | 6.50 | 7.88 |
| | 16 | 6.56 | 7.88 |
| | 23 | 6.56 | 7.81 |
| | 30 | 6.63 | 8.13 |
| October | 7 | 6.75 | 8.19 |
| | 14 | 7.06 | 8.50 |
| | 21 | 6.56 | 8.13 |

1/ Yearly and monthly data are averages of Wednesday weekly observations.

## 7. Denomination and media of payments

As proposed above, the Trust's loans to members would be denominated in SDRs, and it is expected that all operations, assets and liabilities of the Trust would be denominated in SDRs. This approach, which is identical to that followed in the Fund and by the SAF, is intended to minimize exchange risks and costs to borrowers; to avoid any possibility of differentials in risks among borrowers as a result of differing denominations of loans extended to them; and to provide lenders with a common basis for their contributions to the Trust.

It is proposed also, in order that borrowers can be assured of effective use of enhanced SAF lending, that loans to the Trust be made available in freely usable currencies or under arrangements that permit immediate conversion into freely usable currencies or SDRs at the Fund's official rates. It is expected that the media for payments by borrowers to the Trust will be U.S. dollars, and it is proposed that payments to lenders be in U.S. dollars or in other currencies as agreed between the Fund and the lenders.

8. Other financial provisions

a. The Trust would have authority to invest its Reserve and such other balances it might have on hand from time to time.

b. The Fund's expenses in administering the Trust would be reimbursed by the SDA, as is presently the case for the expenses of administering the SAF. It is not expected that expenses associated with administration of the Trust would be substantially greater than those expected for the administration of the SAF nor, except after the termination of SAF operations, distinguishable for the most part from those expenses.

c. The Trust instrument would be subject to amendment by the Executive Board except with respect to certain protected provisions, for example, the purposes of the Trust and the availability of the Reserve to meet the Trust's obligations to lenders.

d. Provisions for liquidation of the Trust would include, inter alia, the disposition of any balances remaining in the Trust.

e. Any question of interpretation of individual borrowing agreements would be settled by mutual agreement between the lender and the Fund as Trustee.

## IV. Operations of the Subsidy Account

An objective of the proposed SAF enhancement is to obtain financing that will permit the onlending of funds to SAF borrowers at a highly concessional rate of interest comparable to that available under the SAF itself--i.e., 0.5 percent. In discussions with potential lenders, they have been asked to consider loans accompanied by arrangements that would permit the onlending of those loans at 0.5 percent. Some have indicated that they are considering internal arrangements that would permit them to extend loans to the Trust directly at that rate; others are considering donations for the purpose of subsidizing their own or others' loans extended at rates above 0.5 percent; and it is possible that the contributions of some will be made exclusively in the form of donations for subsidy purposes.

If all loans were extended to the Trust directly at an interest rate of 0.5 percent, there would be no need for a separate subsidy operation nor any uncertainty about the ability of the Trust to lend at an effective rate of 0.5 percent over time. However, the likelihood that there will be some loans to the Trust at rates above 0.5 percent, and separate subsidy donations, gives rise to a need for estimation of the amounts of such donations that would be required over the life of the Trust and for establishment of mechanisms for determination of actual subsidy amounts and the resulting effective interest rates to borrowers.

The amount of grants required to subsidize the effective interest rate on a loan down to 0.5 percent will depend on a number of factors, many of which cannot be known with certainty in advance. These include the interest rate on the loans to the Trust, which may be fixed or variable over the life of the loan; the period over and rate at which the loan is drawn down; the period over which subsidy grants are received; and the interest returns that can be obtained on the investment of grants received in advance of their use in subsidy payments. As a result of variations in some of these factors over time, it is possible that initial estimates of grants required on the basis of certain assumptions will ultimately prove inadequate to achieve the intended effective interest rate to be charged to borrowers.

Tables 4 and 5 attached provide detailed projections of the subsidy payments that would be required in connection with a loan of SDR 100 million, on the basis of the following assumptions: that the loan is drawn evenly over the 4 1/2-year period 1988-mid-1992; that interest rates on the loan are, alternatively, 6.5 percent and 8.0 percent (corresponding roughly to recent six-month and five-year SDR combined domestic rates, respectively); that all subsidy payments are made at the beginning of each year indicated; and that the Account earns interest at the rate of 7.0 percent on the investment of subsidy donations received and held pending their use.

In discussions with potential contributors, several possible schedules for payments of donations have been mentioned, including a single payment at the outset, payments over three and five years, and payment over the life of the Trust's operations. On the basis of the assumptions noted, as shown in the summary in Table 3, the "up-front" subsidy donation required in connection with a loan of SDR 100 million at 6.5 percent would be SDR 31 million; required donations over the three years 1988-90 would amount to SDR 36 million or SDR 12 million per year, and so on.

Table 3: Projection of Subsidies Required in Connection with Loan of SDR 100 Million 1/

(In SDR millions)

| Payment of subsidy contribution | Total Payments Required to Subsidize Charges to 0.5 Percent on Basis of Assumed Loan Rate of: 6.5 percent | 8.0 percent |
|---|---|---|
| Single payment on January 1, 1988 | 31 | 38 |
| Three equal annual payments 1988-90 | 36 | 42 |
| Five equal annual payments 1988-92 | 40 | 45 |
| Fifteen annual payments 1988-2002 | 46 | 61 |

1/ See detail, Tables 4 and 5 attached.

Even with firm commitments to subsidy contributions (as adjusted to match the size of loan commitments) that would be required on the basis of the specific assumptions used regarding interest rates and investment returns, there would remain the possibility that variations in rates will render these amounts inadequate to enable the Trust to lend at an effective rate of 0.5 percent over the life of its operations. There is also a risk that at times (e.g., early in the Trust's operations) donations actually received and in hand will be inadequate to make calculated subsidy payments, despite the existence of commitments to provide sufficient donations.

If it became apparent that effective interest rates to be charged on enhanced SAF loans would exceed substantially the target of 0.5 percent (either because of a shortfall in initial commitments to make subsidy contributions or because of adverse developments over time in the cost of funds to the Trust), it would be possible for the Fund to seek further subsidy contributions, explore other means of reducing effective rates, or (if at that time loan amounts available to the Trust had not been committed in full to SAF borrowers) reassess the operations of the SAF enhancement. The Subsidy Account Instrument would provide for periodic reviews which would afford an opportunity for assessment of developments and for consideration, if necessary, of means to secure further subsidy contributions. 1/ It would remain possible, however, that amounts available would not be sufficient to achieve the targeted 0.5 percent rate of interest to SAF borrowers, and provision would therefore need to be made for variation of the rate.

1/ It would also be possible, at such time as amounts available to the Trust's Reserve began to exceed its remaining obligations, for the Fund to consider devoting a portion of these "excess" amounts to the subsidization of interest rates on loans by the Trust.

Payments of interest by the Trust in each interest period would be financed from (i) the Subsidy Account and (ii) interest charged to SAF borrowers, as calculated for the relevant interest period. In the event a borrower failed to pay interest due to the Trust, the corresponding amount would be paid from the Trust's Reserve. The Reserve would not be available to supplement the resources of the Subsidy Account, nor would the resources of the Subsidy Account be available to cover overdue interest payments by SAF borrowers.

As noted, it is possible that at times, the amounts actually on hand in the Subsidy Account would not be sufficient to make subsidy payments in amounts calculated on the basis of contributors' commitments. It would seem desirable for the Subsidy Account to have authority to borrow in such a contingency, if a lender were prepared to provide needed "bridge" financing. It is also possible that some contributions to the Account could be made in the form of highly concessional (or interest-free) loans, which would permit the Account to benefit from earnings on the investment of the proceeds of such loans. It is therefore proposed that the Subsidy Account have authority to borrow. Any such borrowing would be exclusively on its account and would not represent a claim or potential claim on the Reserve of the Trust.

It will also be necessary to provide for liquidation of the Subsidy Account. It is proposed that any amounts remaining in the Account upon its termination, after payment of any obligations, be (i) first, up to the equivalent of any amounts that may have been transferred from the SDA in the event such transfers were decided, retransferred to the SDA; and (ii) thereafter, returned to contributors in proportion to their contributions to the subsidy operation.

## V. Summary of Proposals

The following provides a summary, in highly abreviated form for the convenience of readers, of the proposals presented above for the principal financial aspects of the operation of the Trust proposed for the SDR 6 billion SAF enhancement.

### 1. Trust loans to SAF borrowers

a. Commitments in support of three-year programs, disbursements subject to availability of funds.

b. Loans on 5 1/2-10 year maturities, payable in 10 equal semiannual installments.

c. Interest to be subsidized, with the objective of an effective rate of 0.5 percent per annum to borrowers. Any overdue obligations to the Trust, however, to bear interest at cost of funds to Trust.

d. Loans denominated in SDRs.

e. Disbursement of loans in freely usable currency or currencies convertible at the Fund's official rates into freely usable currency or SDRs. Payments to Trust in U.S. dollars.

2. <u>Borrowing by the Trust</u>

a. <u>Security of claims on Trust</u>

(1) A reserve, available as needed to meet any obligations to lenders, to be established and composed of:

(a) Investment earnings on SDA balances held pending disbursement.

(b) Interest on SAF Loans

(c) Repayment of SAF Loans

(d) Any receipts from 1976 Trust Fund after termination of SAF

(e) Net investment income on any balances held outside Reserve

(f) Investment income on all balances held by Reserve

Total of above projected to accumulate to about SDR 4.8 billion by end of Trust operations.

(2) Fund to consider fully and in good faith, if it appeared that any delay in payment by the Trust would be protracted, all such initiatives as may be necessary to assure full payment to lenders.

b. <u>Liquidity of claims on Trust</u>

(1) Transferable on voluntary basis

(2) For lenders electing to enter into mutual arrangements to enhance liquidity:

(a) <u>Temporary</u> suspension of calls

(b) Mutual undertakings to provide <u>temporary</u> liquidity to other "electing lenders," outside loan commitment to Trust.

(3) Any recipient of claims in transfers under (1) or (2) above to accept any renewal obligations associated with those claims.

(4) Recourse to Fund's general resources in event of liquidity need based on need because of developments in reserves (Article V, Section 3(b)(ii)).

c. Loan commitments to Trust

(1) Drawdown periods to run to common date covering Trust's disbursement requirements, illustratively to mid-1992. Precise requirements to be discussed in companion paper.

(2) Some limitation on rate of drawdown acceptable if necessary and requested by a lender--say, not more than 1/3 of lender's commitment before January 1, 1989 nor 2/3 before January 1, 1990.

d. Calls on loans to Trust

(1) Same day, "pass-through" basis, matched with loan disbursements by Trust.

(2) Calls to be initiated only after approval of disbursement to SAF borrowers.

(3) Five business days' notice of call to lenders.

(4) Calls to be arranged in broad proportion to lenders' commitments over time; priority to be given to calls on delayed commitments in order to restore broad proportionality of calls among lenders.

(5) Broad proportionality also as between calls on Trust and parallel bilateral lenders.

(6) Loan disbursements and calls on lenders to be combined on two dates each month.

e. Maturity of loans to Trust

(1) 5 1/2 to 10 years, repayable in 10 equal semi-annual installments, to match Trust's loans to borrowers.

(2) Six-month renewable drawings, with firm assurances regarding renewals to effective term in (1) above; and commitment to equivalent new loan after brief period if a renewal is not agreed.

f. Interest on loans to Trust

(1) To coincide broadly with nature of loan:

(a) Five-year SDR combined domestic rate, established for each call or for all calls, for fixed-term loans.

(b) Six-month SDR combined domestic rate for short-term drawings subject to renewal.

(2) Payable semi-annually, shortly after end-June and end-December.

g. Denomination and media of commitments to and payments to and from Trust

(1) All commitments, loans and other operations to be denominated in SDRs.

(2) Loans to Trust to be provided in freely usable currencies or currencies convertible at the Fund's official rates into such currencies or SDRs.

(3) Payments by Trust to lenders in U.S. dollars or other currencies as agreed with lender.

h. Other

(1) Investment authority for Trust.

(2) Administrative expenses of Fund reimbursed by SDA.

(3) Trust subject to amendment but with protected provisions, including Reserve.

(4) Liquidation provisions to cover, inter alia, disposition of any amounts remaining available in Trust.

(5) Questions under borrowing arrangement to be settled by mutual agreement between Fund and lenders.

3. Operations of the Subsidy Account

a. Paper presents estimates of requirements for subsidy contributions in connection with loans at market rates, on basis of current conditions.

b. Uncertainties, mainly about interest rate developments, will create uncertainty about the adequacy of subsidy contributions to achieve the targeted interest rate of 0.5 percent to be charged to SAF borrowers. Periodic reviews to assess situation, consider possible need for additional subsidy contributions. Provision needed for variation in rate charged to borrowers if subsidy contributions are insufficient.

c. Payments of interest by Trust to be financed, according to periodic calculations, from (i) Subsidy Account plus (ii) interest paid by SAF borrowers. Any shortfalls in (ii) to be paid from Trust's Reserve.

d. Trust's Reserve not to be available for payment of subsidies; Subsidy Account not to be available for coverage of overdue interest payments by borrowers.

e. Subsidy Account to have borrowing authority for "bridging" or to gain net investment earnings on concessional loans.

f. Liquidation provisions regarding any remaining balances to envisage (1) retransfer to SDA of amounts equivalent to any transfers from SDA that may be decided and (2) distribution to contributors to subsidy operations.

Table 4: Enhanced SAF - Illustrative Subsidy Payments for SDR 100 Million Loan - 6.5 Percent Interest Rate 1/

(In SDR millions)

| | Enhanced SAF Loans 2/ | | Annual Subsidy Required at 6.5% | Possible Subsidy Contribution 3/ | | | |
|---|---|---|---|---|---|---|---|
| | Disbursed | Outstanding (end of year) | | All at Outset | Over three years | Over five years | Over life of Loan |
| 1988 | 22 | 22 | 1 | 31 | 12 | 8 | 1 |
| 1989 | 44 | 44 | 2 | .. | 12 | 8 | 2 |
| 1990 | 67 | 67 | 4 | .. | 12 | 8 | 4 |
| 1991 | 89 | 89 | 5 | .. | .. | 8 | 5 |
| 1992 | 100 | 100 | 6 | .. | .. | 8 | 6 |
| 1993 | 100 | 99 | 6 | .. | .. | .. | 6 |
| 1994 | 100 | 93 | 6 | .. | .. | .. | 6 |
| 1995 | 100 | 83 | 5 | .. | .. | .. | 5 |
| 1996 | 100 | 69 | 4 | .. | .. | .. | 4 |
| 1997 | 100 | 50 | 3 | .. | .. | .. | 3 |
| 1998 | 100 | 31 | 2 | .. | .. | .. | 2 |
| 1999 | 100 | 17 | 1 | .. | .. | .. | 1 |
| 2000 | 100 | 7 | 1 | .. | .. | .. | 1 |
| 2001 | 100 | 1 | -- 4/ | .. | .. | .. | -- 4/ |
| 2002 (First half) | 100 | -- | -- 4/ | .. | .. | .. | -- 4/ |
| Total | | | 46 | 31 | 36 | 40 | 46 |

1/ Figures illustrate amounts required to subsidize loan to Trust, bearing interest at 6.5 percent per annum, so as to achieve an effective rate of 0.5 percent per annum on loans to SAF borrowers.
2/ Each disbursement is repayable in 10 equal semi-annual installments beginning 5 1/2 and ending 10 years after the date of disbursement. Disbursements are assumed to be made in equal amounts at the beginning and middle of each year.
3/ Figures assume that available and unused amounts are invested at 7 percent per annum until disbursed.
4/ Rounds to less than SDR 1 million.

Table 5: Enhanced SAF - Illustrative Subsidy Payments for SDR 100 Million Loan - 8 Percent Interest Rate 1/

(In SDR millions)

| | Enhanced SAF Loans 2/ | | Annual Subsidy Required at 8% | Possible Subsidy Contribution 3/ | | | |
|---|---|---|---|---|---|---|---|
| | Disbursed | Outstanding (end of year) | | All at Outset | Over three years | Over five years | Over life of Loan |
| 1988 | 22 | 22 | 1 | 38 | 14 | 9 | 1 |
| 1989 | 44 | 44 | 3 | .. | 14 | 9 | 3 |
| 1990 | 67 | 67 | 5 | .. | 14 | 9 | 5 |
| 1991 | 89 | 89 | 6 | .. | .. | 9 | 6 |
| 1992 | 100 | 100 | 8 | .. | .. | 9 | 8 |
| 1993 | 100 | 99 | 8 | .. | .. | .. | 8 |
| 1994 | 100 | 93 | 7 | .. | .. | .. | 7 |
| 1995 | 100 | 83 | 7 | .. | .. | .. | 7 |
| 1996 | 100 | 69 | 6 | .. | .. | .. | 6 |
| 1997 | 100 | 50 | 4 | .. | .. | .. | 4 |
| 1998 | 100 | 31 | 3 | .. | .. | .. | 3 |
| 1999 | 100 | 17 | 2 | .. | .. | .. | 2 |
| 2000 | 100 | 7 | 1 | .. | .. | .. | 1 |
| 2001 | 100 | 1 | -- 4/ | .. | .. | .. | -- 4/ |
| 2002 (First half) | 100 | -- | -- 4/ | .. | .. | .. | -- 4/ |
| Total | | | 61 | 38 | 42 | 45 | 61 |

1/ Figures illustrate amounts required to subsidize loan to Trust, bearing interest at 8 percent per annum, so as to achieve an effective rate of 0.5 percent per annum on loans to SAF borrowers.

2/ Each disbursement is repayable in 10 equal semi-annual installments beginning 5 1/2 and ending 10 years after the date of disbursement. Disbursements are assumed to be made at the beginning and middle of each year.

3/ Figures assume that available and unused amounts are invested at 7 percent per annum until disbursed.

4/ Rounds to less than SDR 1 million.

## Enhanced SAF: Adequacy of Proposed Reserve

This note reports on simulations regarding the capacity of the proposed Reserve to provide protection for claims on the Trust under certain assumptions regarding nonpayment of obligations on loans to the Trust and the SAF. As explained below, the calculations are purely illustrative and necessarily rely on assumptions regarding the use of the Trust's resources and the mechanism for funding the Reserve which have yet to be determined. Although these assumptions will not necessarily form the basis upon which the enhanced SAF would operate, the results of the calculations suggest that, except on the basis of extreme assumptions regarding nonpayment by SAF borrowers, the Reserve proposed for the Trust would provide full security for claims on the Trust.

### 1. Operation of the Trust's Reserve

Amounts available to the Trust's Reserve are assumed to be those proposed and illustrated in the body of the present paper. The potential adequacy of the Reserve will depend in part on the guidelines for access by individual countries to lending by the Trust, which will need to be considered by the Executive Board. For the purposes of the present simulations, it was assumed that access to the Trust's resources would be differentiated according to financing need and the strength of borrowers' adjustment efforts; that access would in no case exceed 300 percent of quota; that all disbursements would be completed by mid-1992; and that repayments on the Trust's loans would be spread over the period between the second half of 1993 and the first half of 2002. Individual countries' potential needs were estimated on the basis of projections of financing requirements that would emerge in the context of strong growth-oriented adjustment programs for SAF-eligible members during the period 1988-90.

Were no countries to fail to make payments on their obligations to the Trust or the SDA (i.e., on SAF loans), the funds potentially available to the Trust's Reserve could reach a potential maximum of somewhat over SDR 4.8 billion in 2002 (on the basis of present interest rates), the year in which the last obligation of the Trust would fall due. As noted in the body of the paper, however, once the Reserve became sufficient to meet remaining Trust obligations, resources potentially available could be released for other purposes. The projected maximum balance in the Reserve is therefore a notional rather than an actual amount.

### 2. Factors bearing on the adequacy of the Reserve

The capacity of the Reserve to provide security for claims on the Trust will depend, in the first instance, on the accumulation of funds in the Reserve through payments on SAF loans, as well as on the size of the Trust's obligations and the extent and distribution of any risk of nonpayment. The exposure of the Trust would be diminished, and therefore the ability of the Reserve to provide protection enhanced, to the extent that some participants lend directly to borrowers in parallel with the SAF, as is expected, and consequently bear any risk associated with such bilateral loans. To account for this possibility and illustrate its effects, it has been assumed, in one case, in the simulations described below, that SDR 1.5 billion in parallel lending would be available and, alternatively, that the entire SDR 6 billion in enhanced SAF lending would be channeled through the Trust (i.e., no parallel lending).

The number of SAF-eligible countries that have experienced difficulties in meeting obligations to the Fund is relatively small. Some eight such countries (other than Democratic Kampuchea) are presently in arrears to the Fund. Several others have incurred arrears within the last few years but are current now. In total, the countries currently in arrears represent 22 percent of the total SAF group in terms of quota. A larger number of SAF-eligible countries (28 in all) were in arrears to creditors other than the Fund at end-1986; these countries represented 41 percent of the total SAF group in terms of quota. With regard to other possible indicators of payments difficulties, 18 SAF-eligible countries, representing 39 percent of the total in terms of quotas, have sought a restructuring of debt due to official creditors since 1984.

None of the facts noted above should be interpreted as suggesting that any of these countries would not repay their SAF or Trust loans in full. Members have made strong efforts to remain current with the Fund, and major efforts are currently under way to find solutions to the problems of those that remain in arrears to the Fund.

### 3. Illustrative simulations regarding nonpayment

a. In one simulation regarding the possiblity of nonpayment by borrowers from the Trust, it was assumed that 40 percent of the principal on the Trust's loans would not be repaid; and that members failing to pay the Trust would also fail to make payment on their SAF loans, which would correspondingly reduce accruals to the Reserve. As noted, differential access to the Trust's resources has been assumed, while access to the SAF itself is uniform in terms of quota. For the purposes of this simulation, it was assumed that the borrowers failing to make payment to the Trust would have had relatively large access (around 300 percent of quota) to the Trust; their share of outstanding SAF loans would, however, be less than their share of borrowing from the Trust, and was assumed to be 25 percent in this simulation. It was further assumed that no payments by these borrowers of principal or interest on either SAF or Trust loans would be made, beginning immediately following the last disbursement from the Trust. Interest payments would therefore cease in the second half of 1992 under this assumption, and no principal payments at all would be made.

These are extreme assumptions. Nonpayment was assumed to begin immediately upon completion of the borrowers' programs, even though all the conditions relating to their three-year arrangements would have been fulfilled. Although it is to be stressed that this is by no means expected, the nonpayment performance assumed under this simulation would, for example, cover a complete failure to make payments by all of the SAF countries that have been subject to complaints regarding overdue obligations to the Fund.

b. A second simulation involved increasing the proportion of unpaid principal and associated interest on Trust and SAF loans to 50 percent and 38 percent, respectively, with assumptions regarding differentiation of access as outlined above. These ratios would cover nonpayment by a broader group of borrowers.

4. Adequacy of the Reserve under the alternative simulations

a. 40 percent nonpayment of Trust obligations, 25 percent nonpayment of SAF obligations

If parallel lending were provided in an amount of SDR 1.5 billion and the risk on this portion of enhanced SAF lending borne by the bilateral lender, then the total obligations of the Trust, including interest (at 0.5 percent per annum), would be about SDR 4.7 billion. Under the 40/25 percent nonpayment simulation, not only would the Reserve be able to fully cover all unpaid obligations to the Trust, but it would also have by the year 2002 a residual balance of about SDR 1.2 billion.

If the assumption of SDR 1.5 billion in parallel bilateral lending is dropped, the Trust would have to bear the entire risk of the SDR 6 billion of enhanced SAF lending. The nonpayment of obligations assumed under this simulation would result in a smaller Reserve, but the Reserve would still be able to cover the unpaid obligations to the Trust and have a modest residual balance of about SDR 0.4 billion by the end of the Trust's operations.

b. 50 percent nonpayment of Trust obligations, 38 percent nonpayment of SAF obligations

With parallel bilateral lending of SDR 1.5 billion, the Reserve would continue to provide full coverage even if 50 percent of Trust resources and 38 percent of SAF resources were not repaid. Balances in the Reserve would, however, be reduced to a negligible level by the end of the Trust's operations.

Under this simulation and with no parallel lending, the Reserve would become fully exhausted in the latter part of the 1990s and would not be in a position to cover approximately SDR 0.8 billion of the assumed unpaid obligations to the Trust.

## 5. Conclusions

While the proposed Reserve by itself would not be able to provide lenders to the Trust with total protection against risk under all possible assumptions, the simulations summarized in this note suggest that the Reserve could provide full security even under the extreme assumption that 50 percent of borrowers' obligations on loans extended by the Trust were not paid, if some creditors engaged in parallel lending operations, and somewhat over 40 percent if there were no such parallel operations. Beyond the more general qualifications, it bears repeating that it is highly unlikely that countries would cease paying immediately following a period of full compliance under three consecutive annual enhanced SAF arrangements or that such failures would apply to 100 percent of principal and interest through the remaining scheduled lifetime of the loans, which has been assumed for the purposes of these simulations.