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Debt [1 of 2]

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Bank History
Project

Barber B. Conable

BACKGROUND

Debt — BB

Assumptions

(1) $60 billion of commercial bank debt which could be restructured.

(2) Current interest 11%.

(3) Approximately $1.3 billion of Fund standby available.

(4) Bank adjustment lending of $1.5 billion for 3 years equals $4.5 billion. 25% set aside equals $1.1 billion. In addition, we said we might go another 50%, which would yield a total of $1.6 billion assuming we are willing to pull forward for Mexico this means $800 million in the first year.

(5) Total availability therefore is $2.1 billion.

Base Case

Half of debt is swapped at 40% discount.
Half of debt receives an interest rate reduction of 4%.

First $30 billion

Reduction of stock of debt:	$12 billion
Interest rate savings:	$1.2 billion
Interest payable:	$1.8 billion

Second $30 billion

Interest rate savings:	$1.2 billion
Interest payable:	$1.8 billion

Results:

- o Total cash flow savings $2.4 billion.

- o First $30 billion unsecured as to principal and interest. This seems improbable.

- o $1.8 billion of $2.1 billion available used to cover one year interest on the interest due on the second $30 billion.

- o If any security is needed on the first $30 billion debt for debt swap, it presumably would involve defeasance of principal. Broadly, for a 30 year bond the ratio is 13il. Since $18 billion needs to be defeased about $1.5 billion is necessary to purchase zero coupons. This can be funded from a combination of the following sources:

(a) $300 million left out of available $2.1 billion.

(b) Japan might be asked to contribute $500 - 750 million to the debt reduction (post gap).

(c) Commercial banks would lend Mexico $500 - 750 million for 2 years. Repayment as an offset to our second and third year debt reduction releases would be made feasible though this neither could be nor need be a formal "bridge".

(d) Mexico allocates $500 - 750 million as a "bridge" to our 2nd and 3rd year releases.

The World Bank
Washington, D.C. 20433
U.S.A.

Office of the President

April 10, 1989

Mr. F. Aguirre-Sacasa
Mr. F. Vogl

Here are some background issues and papers for your personal use. Please let me know if you need anything else.

Marianne Haug

March 30, 1989

Position Paper on the Brady Initiative

Briefing for Mr. Conable

PRELIMINARY BANK POSITION

(a) General endorsement of the Initiative

- The Bank welcomes the Brady initiative and is pleased to note the endorsement of several of our shareholders for this new phase of the debt strategy. The Bank would like to play a constructive and helpful role in the design and implementation of the actual operations. The Bank also endorses the view that the revised debt workout process must continue to be market-oriented.

    We particularly endorse the emphasis on direct negotiation between the debtor countries and the commercial banks. The role of the official sector should be viewed primarily as being of a facilitative nature.

    The Bank appreciates the earlier initiatives of the Japanese and French authorities and their strong interest in the resolution of the debt issue.

(b) Inadequacy of Resources

- The successful implementation of the initiative would require that the debt and debt service reduction facilitated by the proposed scheme be adequate to fill the financing gaps of the eligible countries. Staff estimates suggest that likely interest savings would be only one-third to one-half of the net commercial bank financing requirements.

    Going ahead without reasonable assurance of adequate financing may jeopardize the success of the entire effort because it will not restore confidence in the economic outlook. Without such assurances, the reversal of capital flight and inflows of direct investment will remain low.

(c) Risks to the Bank of Underfunded Programs

- The scheme as proposed entails significant potential risks for the World Bank. The Bank must therefore have reasonable confidence that these risks will be offset by significant improvements in the debtor's creditworthiness, and specifically that the debtor country's development requirements will be adequately funded.

    Risks facing the World Bank as a result of the proposed scheme stem from three sources:

(i) The potential dilution of preferred creditor debt. Preliminary staff estimates indicate that for the average Highly Indebted Country which participates in the scheme, the share of preferred creditor debt in total public debt will rise from 18 percent to 24 percent and that an additional 26 percent of debt stock will be in the form of partially secured instruments.

(ii) Loss of flexibility in debt management. The dilution of preferred creditor debt may sharply reduce the flexibility in the country's debt structure and pose potentially unmanageable risk to the Bank unless there is a reasonable assurance that external financing will be available on suitable terms and in adequate volume to meet the debtor countries' minimum requirements. The inherent uncertainty of macro-economic forecasts underlines the importance of maintaining flexibility in the structure of debt. If a large proportion of a country's debt service is preferred or partially secured, any adverse shock (external or internal) is likely to affect the country's ability to service its preferred creditors. The risk is less if there is a "cushion" of more easily restructurable debt that can absorb the consequences of unforeseen debt-servicing problems faced by heavily indebted debtor countries.

(iii) Risk of Entanglement. The risk to the Bank depends also on the specific ways in which it is involved in providing enhancement (or security) for debt reduction. Risks associated with particular instruments - interest guarantees in particular - will need to be carefully weighed against their potentially higher benefits in terms of effecting debt reduction and influencing the terms of specific transactions. It may also be desirable to restrict guarantees to particular types of instruments or to situations where there is a greater likelihood of successfully resolving a country's overall debt servicing difficulties.

(d) A Strategy for filling the financing gap

o **Given that the risks to the Bank of an underfunded program are significant, it will be necessary to mobilize additional financing from various sources. Part of the financing gap could be filled from additional official sources, but additional resources will also be needed from the commercial banks in the shape of new money or greater than envisaged debt service reductions (including interest capitalization etc.)**

Part of the financing gap is expected to be met by IMF lending as envisaged in the Brady initiative. Additional adjustment lending and cofinancing from newly raised capital increase of

IADB along with some limited contributions from ASDB for the Philippines and the AFDB for a few African countries, disbursements from untied loans and credits promised by Japan for cofinancing with the Bank or parallel financing with the IMF policy-based loans, and augmented new flows from official export credit agencies are some of the possible sources of official financing that can be tapped. The gap may be partially filled. The scale of these official resources is uncertain at present and should be explored with the relevant authorities.

(e) Changes in Enabling Environment

o To address the issue of underfunding and maximize the leverage of the Bank resources in effecting debt reduction and/or catalysing new money from commercial banks, the creditor governments should make appropriate changes in their tax, regulatory and accounting treatment to favor participants in this operation.

The current regulatory practices, including tax, in most of the G-7 countries must be reviewed to ensure that commercial banks are provided incentives and options that induce them to participate in a debt restructuring plan, be it through provision of new money or debt reduction. The potential penalty for non-participation in these arrangements should act as a powerful deterrent.

(f) Flexibility for the Bank

o The Bank must retain flexibility in the choice of specific instruments of debt reduction.

As the country conditions and market perceptions vary, it is quite conceivable that in some smaller countries the Bank resources could best be employed to support buy backs and achieve substantial relief to the debtor countries. In other cases where the tax and regulatory practices are favorable it may be possible to provide support for interest rate reduction which will be in the best economic and financial interests of the country. The pool of the resources managed by the Bank should not be divided a priori or rigidly allocated according to use of specific instrument. The same principle of flexibility should also apply to the Bank and the Fund to the extent possible.

(g) Country eligibility and Materiality

o Bank support for debt reduction should be subject to certain objective conditions rather than restricted to a list of countries. These conditions would include :

(i) The countries have a credible medium-term adjustment program acceptable to the Bank and a viable external financing plan.

(ii) Where the debt reduction in prospect envisages a substantial gain for the country. (To be defined).

(iii) Where the concessions offered by the banks represent an appropriate burden-sharing response.

ANNEX I

I. SUMMARY DESCRIPTION OF THE INITIATIVE PROPOSED BY MR. BRADY

Debtor Countries

1. Debtor countries should maintain growth-oriented adjustment programs and also take measures to encourage repatriation of flight capital.

International Finance Institutions (IFIs)

2. The IMF and the World Bank would provide funding to 39 countries for debt and debt service reduction by:-

   (a) debt buy-backs

   (b) exchange of old debt for new collateralized bonds at discount

   (c) exchange of old debt for new par value bonds with reduced interest rates.

3. The funding for these operations will be provided in the following manner:

   (a) 25 percent of normal Fund and Bank "allocations" for policy-based lending used to reduce principal of debt through debt buy-backs and collateralized principal reduction.

   (b) Special money pools - to back up interest payments on discounted and par value reduced interest rate bonds traded for commercial bank debt.

4. The IMF and the World Bank would provide up to $20 billion to $25 billion over a three year period about equally divided between "special pools" and reallocations.

5. IFIs may lend to debtor countries for debt reduction operations before financing package is complete.

Commercial Banks

6. Commercial banks are expected to provide debt reduction and new money and support acceleration of debt and debt service reduction through a general waiver of sharing and negative pledge clauses.

Creditor Governments

7. Japan is envisaged to provide about $10 billion over three years as additional financing.

8. Tax, accounting and regulatory impediments to debt reduction should be eliminated.

DECVP
March 30, 1989

The Brady Initiative: Issues for the World Bank

Introduction and Summary.

1. In terms of the evolution of the international strategy for dealing with the debt problems of developing countries, the Brady Initiative is a welcome development. It follows several other official schemes put forward, including the Miyazawa and Mitterand proposals, but is the one most actively under consideration. It recognizes the need for a wider array of tools to restore growth and investment in countries with severe external debt difficulties. The World Bank should be prepared to use some of its resources in support of the debt and debt service reduction measures that are the main focus of the Brady Initiative. (The details of the plan are outlined in an attachment.)

2. At the same time the resources currently envisioned by the Brady Initiative do not appear adequate to meet the debt reduction and financing needs of the debtor countries it is designed to aid. The main issue we must address is whether, at the end of the plan as it is now envisioned, the situation of debtor countries will have improved enough to justify the expenditure of political capital, the extra risk assumed by the Bank, and the expectations of debtor countries. Our tentative answer is no. Without some combination of more official resources--parallel to those available at the World Bank and IMF--and more compulsion on commercial bank creditors to participate in debt reduction and new money exercises, the problem will not be solved. Instead, the Bank will acquire a larger and more risky portfolio of claims on these debtor countries. At the same time, it may be possible to modify the Initiative in directions that would greatly enhance its chances of success.

3. The Bank faces five major issues in its evaluation of the Brady Initiative:

(1) country eligibility and allocations;
(2) the adequacy of the new external resources;
(3) risks to the Bank;
(4) preferred forms of debt service reduction and the need for flexibility; and
(5) the importance of tax and regulatory changes.

Each is summarized below. In some cases, the Bank must make internal policy decisions as to how to formulate its participation in the scheme. In other cases, the Bank must recognize the potential shortcomings of the Brady Initiative. In the coming weeks, the Bank can help shape the scheme into a program that avoids these shortcomings.

4. Country Eligibility and Allocations. The Bank and Fund must develop clear and objective criteria as to the eligibility of countries for Brady Initiative support. Clearly, countries must have in place a viable adjustment

program and a financing plan, negotiated with the Bank and Fund. Both institutions must be in agreement on the form of these programs and on the financing plans that constitute the core of a Brady program. The two institutions may need to tolerate arrears to commercial bank creditors in some debtor countries as the program is set up and the creditor-debtor negotiations take place. The Bank and Fund must agree on the degree to which they will sanction these arrears, during and after negotiations. Eligibility for access to these resources would be developed according to objective criteria but it has to be ensured that the debt reduction in prospect would provide substantial gain for the country. The debt exchanges supported by the Bank should meet a threshold rate of return as high or higher than the rate of return required for other Bank operations. These criteria identify a different set of countries than those identified in the original Brady proposal. A new list of countries should be negotiated.

5. The Bank's support should be allocated in rough proportions to its basic lending program. Any adjustments should be made on an exceptional case-by-case basis.

6. The Adequacy of New External Resources. The preliminary analysis of the Bank staff indicates that the amounts available to support debt reduction on a purely voluntary basis are not adequate to meet the funding needs of the Brady countries. Under the Brady Initiative, as now formulated, debt and debt service reduction would cover roughly one third to one half of the financing needs of eligible countries. The Bank faces two options: (1) argue for more official support--parallel to that provided by the Bank and Fund, in order to spread the risk--of about the same magnitude as that now envisioned from the two institutions; or (2) argue for measures that would increase the leverage of Bank and Fund support for debt service reduction and, where appropriate, concerted new money--"carrots" and "sticks" that would compel commercial banks to participate in debt service reduction and concerted new money exercises. The latter may be more viable. These options are not mutually exclusive. There is a tradeoff between official support and "carrots" and "sticks." A third option is to participate in the Initiative, understanding that it will not resolve the financing problems of most of the larger debtor countries, as a step in the direction of a more comprehensive solution. This option would create potentially unmanageable risk for the Bank.

7. Risks to the Bank. If the Brady Initiative is adopted in its present "weak" form, without adequate assurance of financing necessary to restore growth, the Bank faces the risk of holding, or guaranteeing, much more risky claims on debtor countries. The Bank currently faces a low risk because it holds a relatively small (and preferred) share of large claims on Brady countries. Extreme forms of credit enhancement could grant preferred creditor status to as much as half of the external debt of Brady countries. The Bank should argue for regulatory and tax measures to leverage the use of its funds, and employ extensive direct and indirect credit enhancement only in those cases in which it leads to clearly viable financing situations.

8. Forms of Debt and Debt Service Reduction: The Need For Flexibility and Conditions for Bank Support. Pure buybacks provide permanent debt service relief. In small countries that have little chance of regaining access to commercial markets in the near future, buybacks appear to be the most

straightforward method of achieving debt service reduction, although the contribution of commercial bank debt service reduction to the financing needs of these countries will be smaller. In larger countries whose debt is owed mainly to commercial banks, buybacks would have to be massive to meet the debt service reduction needs necessary to fill financing gaps. Exchange offers with reduced interest rates, combined with new money where appropriate, appear to be a more attractive option. Exchange offers create the possibility of more leverage, through regulatory and tax incentives, and are more compatible with program conditionality. The Bank must maintain its flexibility in its choice of the form of debt or debt service reduction that would be appropriate to the circumstances of each country. Bank support should be limited to those debt and debt service reduction measures that: (1) provide a substantial gain to the country; and (2) represent appropriate burden sharing by the commercial banks. To be effective, the regulatory and tax incentives in support of debt reduction should be in place before or concurrent with debt exchanges.

9. Tax and Regulatory Measures. Since the staff's analysis indicates that the debt reduction measures currently envisioned in the Brady Initiative will not be adequate, tax and regulatory measures may be required to ensure that commercial banks do their share. The Bank staff is working on these issues but one of the proposals under consideration is to provide differential treatment for the banks participating in the new money and debt reduction exercises and non-participants. The Bank should encourage the G-7 countries to review current regulatory and tax policies to ensure that commercial banks are provided with the proper incentives.

10. Each of these issues is addressed in more detail below.

I. Country Eligibility and Allocations.

11. The Bank and Fund must develop objective criteria for the selection of countries eligible for the program. To be eligible, a country must have in place a comprehensive adjustment program and have worked out a viable financing plan. Unlike the recent past, Fund and Bank support will not be contingent on having financing, as opposed to a financing plan, in place. Under the Brady Initiative, a country would develop a financing plan and discuss it with the Bank and Fund. The two institutions would commit financial support before the start of creditor-debtor negotiations.

12. It is likely that many debtor countries will go into arrears to commercial bank creditors at some point during the negotiation process. The Bank, Fund, and regulatory authorities must consider their policy stance concerning arrears to commercial bank creditors that resist negotiating or signing agreements which fit an "approved" financing plan. The dilemma here is how to tolerate arrears which do not reduce the debtors' incentive to adjust but at the same time reduce the scope for eliminating free riders.

13. The 39 countries identified by the Treasury as eligible for assistance (on the basis of having rescheduled commercial bank debt since 1983) include ten small African countries that owe less than 10 percent of their debt to commercial banks. There is a good argument for including these countries, as a small amount of official finance could greatly reduce or eliminate the commercial bank debt problem in these countries. However, the

contribution of commercial bank debt reduction to the financing needs of these countries will be small.

14. In order to determine eligibility of the countries that can participate in the debt reduction exercise certain objective criteria would need to be developed. These criteria would use the various magnitudes and measures of debt and debt service burden. Of course the requirement of Bank-Fund adjustment programs and financing plans would be prerequisite for eligibility but the guiding principle would be that the country receives a substantial gain from debt reduction.

15. The country allocation of Bank funds in support of Brady activities should reflect the existing lending program for these countries, what other creditors are providing in parallel financing and the resulting exposure implications for IBRD. It is desirable that the resources of the Fund and the Bank be linked in some way in order to facilitate common judgments concerning the adequacy of the adjustment program and associated tranching; flexibility in use of resources across countries and instruments; and avoidance of distinctions in the relative rankings of the two institutions as creditors.

II. Adequacy of Official Resources Available in Support of the Brady Initiative.

16. The major issue for the World Bank is its assessment of the amount and degree of debt relief the Brady Initiative can achieve, relative to the size of the debt problem of eligible countries. The scheme must provide the amount of relief that is necessary for adequately funded adjustment programs. Underfunded programs will not restore growth and will put at risk the extra resources provided by the Bank and Fund.

17. The actual relief, i.e., the reduction in net resource transfers by debtor countries to their creditors will depend on a number of factors: (a) the size of the discount on the existing loans; (b) the form of debt reduction (buyback, interest rate reduction, etc.); (c) the differential in interest rate between the commercial bank loans and the WB/IMF loans used for debt reduction; (d) the additionality of new money and net lending from commercial banks and/or officials sources and (e) the strength of the tax and regulatory measures.

18. Preliminary analysis undertaken by Bank staff indicates that debt reduction and debt service reduction, as outlined in the current version of the Brady Initiative, will not meet the external financing needs of the target countries or the 20 percent debt and debt service reduction goal of the U.S. Treasury. On the assumption that approximately $24 billion of IBRD and IMF funds would be used to finance or guarantee debt reduction--roughly half diverted from currently planned operations and half from new operations--the Initiative would generate about $4-6 billion per year in net savings on external resource payments, about one third of the annual financing gap estimated for these countries over the next three years.

19. The criteria for the provision of new money versus debt reduction in a financing plan is an issue for internal Bank discussion and for discussion with outside agencies. Where the debt overhang is large, relative to the

potential economic capacity of the country, new money should not be part of a financing plan until the Bank is convinced that debt reduction measures in place are adequate.

20. Staff analysis indicates that new money will be necessary and appropriate in many countries. Concerted lending may continue to be a major component of financing packages. With specific waivers of sharing and negative pledge clauses, which discourage creditor free riding, and without the pressure on debtors to reach agreement in order to gain access to Fund or Bank credit, debtor countries and their creditors may come reach accords on new money packages (implicit interest capitalization) that are more generous in terms of financing adjustment and investment than those of the recent past.

21. As noted above, the staff's preliminary analysis indicates that the level of support currently envisioned from the Bank and the Fund, while likely at the limit of prudence for the two institutions, would not be adequate to meet the financing needs of the Brady countries. Additional support from surplus countries for debt reduction and for the provision of new money, where appropriate, would clearly enhance the attractiveness of the program to debtors and creditors.

22. The Japanese and other official bilateral funds envisioned under the Brady Initiative could be utilized to cofinance Bank new money to the beneficiary countries, to supplement the "pool" for interest guarantees, or added to "set aside" funds for collateralized exchange offers. To the extent that the Bank's adjustment loans to Brady countries are partially used for financing debt reduction, the shortfall in current account financing will be accentuated. Official bilateral new money could substitute and fill the gap.

III. Risks to the Bank

23. The Bank currently faces a low risk of payments arrears and other debt service interruptions because it holds a relatively small and preferred share of the external debt of each of the individual Brady countries. If the Brady plan is adopted in its present form, not being adequate to meet the funding needs of the Brady countries and not accompanied by sufficient financing to restore growth in the Brady countries, the Bank faces the risk of holding, or guaranteeing, larger shares and larger amounts of claims on these debtor countries. Some of the debt reduction schemes envisioned would grant preferred creditor status to as much as half of the external debt of Brady countries by 1990, a more than doubling compared to a without-Brady scenario. The fact that the debt will be bought at a substantial discount, reflecting the uncertainty regarding the full servicing of the debt, indicates that the claims taken on will be risky and can increase the overall risks the Bank.

24. The Bank also faces an increased risk of entanglement of its claims with those of the commercial banks if its share of debt is drastically increased and if it uses its involvement with the country as a source of comfort to the creditors in the case of not-fully secured debt conversions. To the extent that the lenders perceive that the involvement of the Bank is increasing the likelihood of full repayment on replacement instruments beyond the amount explicitly secured by the Bank, the creditors will be willing to accept a larger discount and a larger amount of debt reduction can be

achieved. However, the larger the amount of this extra benefit, the larger the involvement of the Bank and the larger the risks the Bank will take on.

25. One way for the Bank to limit these risks is to reduce the price at which it is able to buy (or convert) the debt of the Brady countries relative to the use of its resources and the degree of its entanglement. The Bank will have to argue for regulatory, accounting and tax measures by the creditor countries' governments which will leverage the use of its resources sufficiently, and design debt reduction and conversion instruments, accordingly, to achieve this. Alternatively, official creditors could mobilize a large pool of funds outside of the Bank to use for large scale debt reduction.

IV Forms of Debt and Debt Service Reduction: the Need for Flexibility for the Bank and Conditions for Bank Support.

26. Debt service relief can take several forms: new money; cash buybacks; old debt for new debt exchanges in which the new debt carries a lower face value (Mexico-Morgan) or a lower interest rate (Brazil exit bonds) or both; and debt-equity swaps. Debt exchanges can be "credit enhanced" through guarantees, collateral, or some form of senior creditor status. In the extreme, a fully guaranteed or collateralized exchange is equivalent to a buyback.

27. Bank credit enhancement techniques must be examined. Alternative forms of credit enhancement include guarantees, lending for collateral to be placed in escrow accounts, stand-by lines of credit or combinations of these techniques. At an abstract level, all forms of credit enhancement are equivalent. However, Bank bondholders, commercial banks and their regulators, and the debtor countries may value these instruments differently. The Bank should investigate the advantages and disadvantages of alternative credit enhancement techniques. In order to avoid taking on excessive risk, the Bank should minimize credit enhancement and entanglement and maximize leverage through regulatory and tax measures.

28. Forms of debt exchange that provide immediate interest rate reductions appear to offer the most benefits to debtors and creditors. Interest rate reduction may allow creditors to carry the new claims on their books at face value. There is a greater possibility for increased leverage in debt exchanges, over pure buybacks, in the form of senior status for the new debt. Interest rate reduction for a specified period of time, five years for example, appears to be an attractive option to consider, as it leads to a large measure of short-run liquidity relief with a smaller reduction in the present value of the contractual obligations.

29. The type of conditionality connected with Bank financial support will be affected by the form of debt service relief. New money can be tranched. Buybacks would require prior adjustment measures. Debt exchanges can be designed to provide relief conditional on policy performance. For example, interest can be reduced if adjustment measures are followed or capitalized if policy performance deteriorates.

30. Forms of debt reduction will influence the sequencing of debt

relief. The Initiative can provide debt relief in a series of operations over the three years or relatively quickly, at the beginning of the adjustment program period. If pure buybacks are the major tool, sequencing provides a greater degree of policy conditionality leverage but reduces the cash-flow benefit. Immediate cash-flow needs argue for quick debt exchange agreements with commercial creditors, incorporating conditional interest rate reductions. Work under way by Bank staff suggests that buybacks should be one-time operations in order to discourage creditors from holding out for better prices in subsequent buyback operations.

31. Pricing of debt buybacks and exchanges is also an issue. Bank support should be limited to transactions that represent a substantial gain to the country and where the concessions offered by banks represent an appropriate sharing of the burden. While the prevailing secondary market price can be taken as a rough benchmark, efficient bidding procedures and guidelines that help to establish the price at which the debtor can buy back or exchange new debt for its existing obligations need to be established, especially for operations involving the use of Bank resources and guarantees. Prices may tend to rise as new resources are devoted to buybacks; commercial banks may tend to benefit disproportionately. (Secondary market prices of the debt of likely beneficiary countries has risen as much as 20 percent already, indicating that commercial banks expect to benefit from the Initiative.) Work undertaken by Bank staff suggests that a minimum threshold discount, mentioned under the discussion of financing plans, or an acceptable rate of return would help to alleviate this problem. (Commercial banks may discover that the prices may not rise as much as they anticipate. If the increase in preferred creditor debt as a result of the debt reduction program is significant, the remaining subordinate debt may rise very little in value.)

32. For these and other reasons the potential benefits of buybacks for the debtor country are still being debated as they depend on a number of factors including the features of the specific deals. A comparison of cash flows after the buyback to a situation in which debt is serviced in full, and an associated calculation of rates of return, may not be appropriate when there exist a real possibility of less than full debt servicing by the debtor country. It remains, therefore, essential that the Bank retain its flexibility in the use of its funds on a case-by-case basis and determines whether or not buybacks and debt exchanges are beneficial to the country in light of the specific circumstances of the country, including the potential alternative use of the resources provided by the Bank.

V. Tax and regulatory measures.

33. Preliminary analysis indicates that the debt reduction measures in the Brady Initiative, based on the current levels of envisioned external support, will not be adequate to meet the financing needs of the Brady countries. Tax and regulatory measures may be required to ensure that commercial banks do their share. The Bank should encourage the G-7 countries to review current regulatory and tax policies to ensure that these policies provide commercial banks with incentives to participate in appropriate new money and debt reduction exercises. Work undertaken by Bank staff suggests a number of measures available to creditor country governments that would help to achieve these ends.

34. The importance of these tax and regulatory measures means that they cannot be delayed; these changes should be negotiated quickly. These measures must be in place before or concurrent with the introduction of Bank and Fund assisted debt reduction plans.

MR. CONABLE'S NOTES

OF APRIL 3, 1989

Brady

Structural macroeconomic support by Bank and Fund. Investment flows important. Fund should monitor flight capital. Negotiate general waiver for Banks of three years. Bank and Fund policy-based programs adapted to support debt reduction. Interest reduction on rolling basis limited period of time. Rigidities reduced--visible support from the outset. Fund and Bank should release after waiver agreed to, before Commercial Bank agreement. Bilateral support (Japan).

Aspe

Front loading needed, not reliance on flight capital. Mexico has been in adjustment for a long time, does not have to earn debt relief now. Debt relief should not be passed out piecemeal over several years.

Beregovoy

Debt reduction needed for growth. Guarantee fund endowed by SDR allocation and multilaterally managed, urged by Finance. Japanese made similar offer. Brady Plan another advance and we must now agree on modalities. Four points:

1. Case-by-case with support of Fund and Bank.

2. Maximum leverage--debt interest reduction.

3. Additional financing not from old resources. SDR Plan better.

4. Each category of creditor gets risk in response to its commitments.

Must accept risks to the public sector.

Sumita

Growth and case-by-case still valid. Medium-term economic adjustment needed. Sharing needed, as anticipated in Brady Plan. Four points:

1. Medium-term plan with Fund needed. Flight capital.

2. Debtor and commercial banks must negotiate reduction.

3. Strengthened role for Fund and Bank. Special set-asides necessary, plus more resources especially for Fund.

4. Japan increase parallel lending.

Exim Bank will make $4.5 billion available over next several years.

Stoltenberg

1. Yes, but new ideas to be studied without too big a package. Disagrees with Beregovoy, and don't postpone because of dangers involved. General solution without preconditions not good, because of good performers.

2. Reduce principal first, interest only under certain conditions. Amounts of additional first support too early to state.

3. Later. Big question is how to reduce debt not new types of new money.

4. Criteria, not a list.

5. Guarantees not necessary. Loan with enhanced loan part can buy enough guarantee.

6. Possible a minimum. Substantial discount needed.

7. Must be studied further, but probably less.

8. Needs to be studied.

9. Risk should not be transferred to public. If new lending by commercial banks, no guarantee either.

Nobrega

Poor response to Brazil's efforts. Negative flow with World Bank $1.4 billion from Japan only good news until debt reduction plan.

1. Debt Equity not good for Brazil's economy.

2. Recycling interest payments.

3. World Bank and Fund contribution necessary.

4. Deregulation of Banks.

5. Don't damage those who have avoided rescheduling.

Brazil will continue to adjust, but must show show results:

1. Growth resumed.

2. Total solution, not just a step.

Capital flight not as bad as suggested -- due to lack of confidence and deep rooted medium-term growth problem perceptions. Debt reduction most important element needed.

Lawson

Eight out of nine for Stoltenberg, but in number 8, new stage of existing strategy. Fund and Bank do not need substantial existing amounts.

1. Existing strategy kept by putting burden on debtors to reform.

2. Debtors negotiate with creditors--industrial countries should not intrude. Paris Club has rescheduled $87 billion. Bank's fully paid on interest.

3. Next phase reduction, but no transfer to public risk. Agreed set-aside for buy-backs, even if only a modest dent in stock of debt. Tax and regulatory framework should be reviewed, bilateral ad on voluntary basis.

4. Fund and Bank should not reward bad performers.

5. No need for quota increase now--nor SDR allocation.

Petersen

Agree with direction of Stoltenberg. Market based and voluntary solution best. Debt reduction benefits balanced against long-term costs. Debt reduction and new money basically incompatible--confidence depends primarily on policy change. Regulatory and tax changes needed. Brady's initiative applauded but integrity of Bank and Fund must be preserved--no guarantees. Too much involvement in debt reduction could hurt traditional work and transfer too much risk to Bank and Fund.

Noriozua

Low income solution by Paris Club. Speed and upfront aid needed.

Sathrakerl

Brady initiative welcomed as move in the right direction. Coverage must be expanded to all, including official debt and par value debt. Fund should be catalytic only, not just more resources in.

Al Sayari

Step in right direction. All should benefit, provided serious reform. What about special financing facility for fund, since this is an exceptional circumstance?

Wilson

Expectations are high, although we are talking only about a step. Don't undermine IFI's traditional role. Commercial banks seem to think this is the only game in town.

Entice commercial banks to give big discounts. Perhaps backload rather than frontload discounts.

Concerned about acceptability of waiver. Canadian banks resist on general waiver.

How can debtor countries entice more equity capital investment. F&B should identify these more.

Adequacy of resources? National allocation among qualified members, so enough will be available for all w/o too much exposure.

Urgency needed.

Amato

No banks should be barred from contributing to solution. Without debt service reduction, plan won't work, despite risks. Maximize leverage is needed and debt service reduction does it. IFI's must work or technicalities to minimize difficulties.

- Questions 2 & 3: Yes, under certain conditions.
- 4 - Criteria - good performance.
- 6 - ?
- 7 - Yes
- 8 - French proposal should be considered. Review of quotes before end of year.

Brady

Transfer of risk - do not favor - but risk is being transparent now. Any statement or risk transfer should be tightly stated.

Dusenberg

Brady transfers risk, but ti should be defined and contained quid pro quo for debtors in policy change. Waivers will be necessary. Brady expects additionality from IFI's, but no guarantees from Fund. Regulatory change towards uniformity.

Maystadt

Debt reduction strategies ar enot better than new money. No objection to IMF facilitating, but assets therefore must be additional. That is why Belgium wants SDR allocation, rather than existing resources. Cross default with Fund could give incentive to banks that reschedule or reduce.

Al Southery

Pragmatic solution needed. US has not been helpful.

Chavan

No consensus. Big problem if stated as agreement in principle. What is the hurry in decision? Criteria must be universal and resources must be protected.

Okongwu

But debt reduction necessary, with performance criteria. Brady a good initiatiave, but no idle resources in F & B. Quota increase should set aside some for debt reduction. Possibly a new agency to do this? B & F should study and advise. Question 2: Answer unknown. Question 3: Where do funds come from? Question 4: List not needed. Question 5: Unknown. Question 6: Market determined. Question 7: M.D. Question 9: Already transferred to public sector.

Managing Director

F encouraged to consider, with prudence, how proposals can be effectively implemented. F & B will work together. Case-by-case encouraged, with performance differentiation, as best protection against risk of moral hazard. All members must be included. Must find most efficient way to be supportive, most leverage. Bank & Debtor country must work out discount directly. Amount of resources to be devoted to new initiative. Financial integrity must be preserved and traditional role must be maintained. Catalytic work must be limited but sufficient.

There is no additional risk or service without cost. In this case to IFIs. There is a large expectancy - all our customers are indebted. The option of debt reduction is a valuable addition to strategy.

Interim Committee

Meeting Monday April 3, 1989 (afternoon)

Agenda item 4: Debt Strategy

Note from the Chairman of the Interim Committee

Members may wish to address the following questions:

1. Does the Committee intend to reach agreement first on a number of essential principles and criteria related to debt and debt service reduction in order to establish a framework for a new strategy and for the role of the IMF (and the World Bank) in this strategy? Does the Committee (also) wish to to reach agreement in this meeting on amounts of debt and debt service reduction that may result from this new strategy?

2. Will the focus of the new strategy be on reduction of the amounts of principal of outstanding debt or on reduction of the amounts of debt service (interest) payments or on both? And will the Committee be able to agree on the amounts of (additional) financial support from IMF (and World Bank) in these transactions of debt and debt service reduction over a period of, say, three years?

3. Does the Committee wish the IMF (and the World Bank) to provide some form of financial support to debtor countries both for reduction of their outstanding stock of debt and for their efforts to obtain new loans from the commercial banks? Or should the IMF (and the World Bank) limit its financial involvement to the debt reduction as such?

4. Which highly indebted developing countries will qualify for making use of this new strategy of debt and debt service reduction? And when? And in which order?

5. Will there be any formal or de facto guarantees by IMF and/or World Bank? And if so, will facilities of credit enhancement be available to the remaining stock of outstanding claims of commercial banks or to new loans by commercial banks or to both?

6. To what extent will the Committee indicate the size of the discounts in debt reduction transactions concerning commercial bank claims? Or will that be left entirely to the market and to the negotiations between individual debtor countries and their creditors?

7. Does the Committee expect that debt reduction through transactions involving substantial discounts on commerical bank loans will be compatible with (simultaneous) new lending by the same commercial banks to the same debtor countries?

8. If the IMF and/or World Bank are going to make available substantial additional amounts for the implementation of the new debt strategy of debt and debt service reduction, how will this affect the financial integrity of the institutions and the quality of the claims of member countries and (other) creditors on the institutions?

9. The Committee has stated in its communique after its meeting in Berlin of September 26, 1988: "The Committee agreed that the menu approach should be broadened further, including through voluntary market-based techniques which increase financial flows and which reduce the stock

of debt without transferring risk from private lenders to official creditors." Does the Committee still hold this view and how does a new debt strategy fit into this statement of principle?

Aspe

Fiscal over expansion led to debt crisis. Capital flight exaggerated it. In 1983 structural adjustment began. Government spending was cut by 10 points GDP and revenues increased by 4 points GDP. After six years, Mexico still has severe problems.

1. Terms of trade deteriorated 42%
2. Real interest rates are above long-term trends of 1982.
3. Commercial banks have not been lending.

6% GDP transferred to rest of world in each of recent years resulting in debt overhang.

Debt cannot be serviced, so Brady initiative welcome.

Private investment won't come, because of debt problem. Labor force growing 4% a year now. Mexico willing to deepen adjustment; it is doing it.

Bank options:

1. Old debt for new bonds at a discount
2. Old for new debt with lower interest rates
3. New money--medium-term Bank and Fund
4. Capitalization of interest.

How can Bretton Woods (BW) help? WB: Our projects bring 13-20% rate of return. To get higher rate of return, just have debt reduction. Moreover, transaction had 32% return. Market discounts transaction would have 52%--only direct benefits. No other project has a higher rate of return.

Dallara

Will not reiterate plan.

1. US is encouraged by discussions even though not purely US proposals.
2. Broad concepts and general approaches so others can develop outline and details
3. Two institutions must now act urgently.

Camdessus

Resources needed, while preserving principles. Deep reform necessary. Catalytical role--financing limited. How much do we spend on debt reduction? Adjustment still necessary.

Conable

I supported--talked about the costs and some about the exposure.

Ruding

Must not bail out bankers. Must offer them something, but no openhanded commitment. How can Mexico recapture confidence on capital flight? What about population programs?

Beregovoy

Resources are needed. Timely results needed. Diversify solutions but some sort of guarantee or support needed. Climate of trust between debtor countries and banks. IFIs must work flexibly.

Aspe

Capital return requires more than good economic policy. Debt overhang drives it away. 1.9% population growth. More exposure but lower debt.

Caines

Please be careful.

Berrada

Should I negotiate with London Club?

Chidzero

What about Zimbabwe? Should we join the band wagon.

Camdessus

You deserve adequate support.

Draft Operational Guidelines
World Bank Financial Support for Debt Reduction

1. The Bank will provide financial support for debt reduction transactions provided that the borrower has:

(a) committed to, and is in the process of implementing, a comprehensive medium-term adjustment program acceptable to the Bank;

(b) developed a viable, medium-term external financing plan that includes realistic objectives and approaches to debt reduction.

2. The amount of financial support that the Bank will provide will be determined on a case by case basis, up to approximately 40% of total adjustment financing operations [i.e., 25% of presently planned commitments plus a matching amount from the "pool" of $6 billion in additional commitments].

3. Commitments will be tranched over 2-3 year periods, subject to trance release conditions typical of Bank adjustment lending. Drawdowns may be front-loaded up to [50%] over the first 12 months.

4. Within the overall commitment limit for a specific debt reduction program, Bank resources may be drawn down for any of the following purposes, subject to the general conditions set out below and Bank management review of the terms of specific transactions:

(a) Loans to finance buyback operations. The Bank will finance up to 50% of specific buyback operations that are expected to result in, or are clearly linked to, comprehensive resolution of a country's debt servicing problems. The Bank will need to be satisfied as to the objectives and procedures to be followed in the buyback, including inter alia (i) adequate safeguards against "free riding" , (ii) evidence that the bidding/tendering process is professionally designed and fully competitive, and (iii) likelihoo that average tender prices will be reasonably close to prevailing secondary market levels. In no event will the Bank finance a buyback operation where the [average] [maximum] price paid exceeds [two-thirds] of face value.

The terms and conditions of such loans will be those normally applie to the country concerned, including standard currencies of disbursement an repayment. Although not a condition of such loans, it is expected that lending by the Bank to finance buyback operations will be in parallel with

IMF loans for the same purposes. Cofinancing from other sources equal to a least 50% of the transaction value will be required in any event.

[Note: these conditions will exclude direct use of Bank resources for buyback programs that operate continuously and are designed to absorb debt out of the secondary market over a period of time. Borrowers will be free to negotiate and operate such programs (provided they can secure the necessary waivers), funded out of general revenues or reserves, a portion o which would obviously be traceable to Bank lending for adjustment purposes. The effect of these conditions is to limit direct Bank support for buybacks to the smaller countries where comprehensive settlements may be possible and where multilateral support is available.]

(b) Loans to finance collateral for debt exchange transactions. The Bank will finance the purchase of collateral to cover (i) defeasance of principal in debt exchange transactions and/or (ii) a portion of interest payments. Borrowers will be encouraged to secure cofinancing from other sources, including in particular the IMF. In no event will the Bank finance more than [25]% of the present value of the instrument being secured (calculated according to a methodology acceptable to the Bank).

Loans for the purpose of providing support to interest payments may be in the form of either: (i) full and immediate disbursement into trust or escrow accounts; or (ii) revolving lines of credit, including syndicated lines of credit involving other lenders. The maximum terms for such loans and credit lines will be those normally applied to the country concerned [and may be shorter depending on the specific transaction]; to the extent possible the Bank will make currencies available to the borrower appropriate to its escrow obligations [and will assist borrowers in managing exchange risks associated with significant mismatches between escrow/trust fund assets and repayment obligations to the IBRD].

The terms and conditions of specific debt exchange transactions will be subject to World Bank review. The Bank will need to be satisfied that exchange prices are competitively determined and reflect current secondary market conditions. The Bank will not provide financing for transactions for which the [present value reduction] [discount] is less than [one-third] of face value. [This condition needs to be reviewed carefully and expressed more precisely.]

(c) Guarantees on interest payments on debt exchange transactions. The Bank will provide selective, limited guarantees to cover interest payments on debt exchanges where: (i) the instrument to which the guarantee applies is not part of a general debt restructuring agreement, is specifically exempted by the borrower from restructuring and "new money calls", and has other enhancements/characteristics that distinguish it from existing commercial bank restructuring agreements and syndicated credits; or (ii) the guarantee facilitates a comprehensive restructuring of a country's external debt service obligations and resolution of its debt service problems.

Guarantees will be provided only for minimum interest rates, normally well below current market levels and determined on a case by case basis but in any event not to exceed [6]% p.a. The Bank will guarantee up to three years' payments at the minimum rate, on a rolling basis, but arrears on the unguaranteed portion of interest due may not be used to trigger a ca on the guarantee.

The term of the guarantee will initially be for [5] years, but may be extended up to a total of [10] years at the World Bank's option. Once called, rolling guarantees will be reinstated only at the option of the Bank and only if the events triggering the guarantee are satisfactorily remedied by the borrower. In no event will such guarantees account for more than 20% of the present value of the instrument involved (calculated in a manner satisfactory to the Bank).

The Bank will not agree to subordinate its claim on the borrower under its counter-guarantee agreement, nor will the Bank accept restrictions on its rights to settle its claim with the borrower in a manner acceptable to the Bank.

The Bank will charge a flat fee of %.

March 15, 1989

BACKGROUND INFORMATION ON U.S. SUGGESTIONS TO STRENGTHEN THE DEBT STRATEGY

This summarizes U.S. suggestions to strengthen the current international debt strategy. These are not definitive proposals, but a suggested approach to help guide international efforts to strengthen the debt strategy. We will need to work closely with key creditor and debtor governments, the commercial banking community, and the international financial institutions to strengthen the strategy. Progress will, of course, depend upon each party fulfilling its responsibilities in a cooperative international effort.

- Builds upon the fundamental principles of the current strategy, including the vital importance of:
  - stronger growth in debtor nations;
  - debtor reforms to achieve that growth;
  - external financial support; and
  - a case-by-case approach to individual nations' problems.
- Focuses international efforts on achieving more rapid and broadly based, voluntary debt reduction during the next three years in order to ease debt burdens and improve prospects for stronger growth.
- Recognizes continuing need for new lending from commercial banks, while placing stronger emphasis on new investment flows and the repatriation of flight capital.
- Maintains a central role for the IMF and World Bank within the debt strategy in encouraging debtor policy reforms and catalyzing financial support.
- Redirects and increases available IMF and World Bank resources -- from their current capital stock -- to support debt and debt service reduction transactions agreed upon by commercial banks and debtor nations as an additional spur to growth in debtor nations.

Role of the IMF and World Bank

- IMF and World Bank programs should continue to promote sound policies, with special emphasis on specific measures to improve the investment climate and encourage repatriation of flight capital, in addition to vital macroeconomic and structural reforms.
- Debtor nations which wish to engage in a debt reduction program should develop policy reform programs with the IMF and World Bank, as a condition for access to financial support for debt reduction.

- At the same time, commercial banks and debtors should negotiate general waivers covering such areas as the sharing and negative pledge provisions in existing commercial bank agreements which could come into effect when IMF and World Bank disbursements become available.

- These waivers should have a life (perhaps 3 years) and provide a framework for multiple transactions between the debtors and banks to reduce debt and debt service.

- Once a general waiver has been agreed upon, a portion of IMF and World Bank policy-based loans could be made available to support debt reduction operations. The set-aside amounts could operate as standby credits to collateralize discounted debt/bond agreements or to replenish debtor reserves following cash buybacks during the period of the loan.

- For debtor nations which have negotiated agreements to reduce the stock of debt, the IMF and World Bank could also make available support for interest payments on a rolling basis for a limited period. Such support could be available for debt restructurings or exchanges which involve either a substantial discount of principal or a major reduction in interest rates.

- Initial disbursements of IMF and World Bank loans could occur prior to completion of negotiations with commercial banks, in order to provide prompt support to debtor country reform efforts.

Paris Club/Official Creditors

- The Paris Club should provide continuing support through rescheduling based on debtor performance, with agreement contingent upon an IMF standby program or extended financing program (EFF).

- Key creditor countries should also seek to assure continued access to official export credit support for debtor nations adopting Fund and World Bank programs.

- More generally, creditor nations should review regulatory, accounting, and tax provisions with a view to reducing or eliminating impediments to debt reduction, where they exist, while maintaining the safety and soundness of the financial system.

- It is also hoped that creditor countries that are in a position to provide financial support to this effort would do so.

Negotiations with Commercial Banks

- o These ideas could be phased into ongoing discussions in order to avoid any interruptions in orderly relations between creditors and debtors.

- o The debtor nation should work out with commercial banks a range of debt or debt service reduction instruments as a central element of meeting the debtor's financing needs.

  -- Upon completion of negotiations between the debtors and the banks, it would be possible for banks to undertake a variety of debt and debt service transactions simultaneously during the three-year period, without requiring separate waivers of sharing and negative pledge clauses in existing commercial bank agreements for each transaction.

  -- Debt reduction transactions might, for example, include the offer of specific instruments (such as debt/bond exchanges) to all commercial banks, cash buybacks up to a maximum amount, and/or the negotiation of specific debt/equity or non-collateralized interest reduction instruments with individual banks.

  -- As part of the debt reduction program, effective debt/equity programs (which do not require waivers) should remain open in the debtor nation.

- o Additional new financing commitments will also be needed, as well as capital flight repatriation and new investment, to enable the debtor nation to meet its remaining obligations on a timely basis.

  -- New financing commitments could include concerted lending, club loans by a group of banks, or a range of trade, investment, or other credits from individual banks. In some cases, this might involve a differentiation of new loans from old debt.

- o The debtor nation should report to the IMF on progress in negotiations with commercial banks on a quarterly or semiannual basis.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Delivery
Expected at 11:30 A.M.
March 16, 1989

Statement by the Honorable David C. Mulford
Assistant Secretary of the U.S. Treasury
for International Affairs
before the
Subcommittee on International Development Finance,
Trade and Monetary Policy
U.S. House of Representatives

Mr. Chairman and members of the Subcommittee:

I welcome this opportunity to discuss the three reports that were transmitted to your full Committee, the Administration's review of the international debt strategy, and our suggestions for strengthening international efforts to alleviate the debt burden in developing countries.

In mid-December, then President-elect Bush called for a thorough reassessment of current public policy on this issue. At that time, the Treasury Department was in the midst of preparing reports, as required by law, that have had a direct bearing on the policy recommendations that we have developed. Therefore, I will open my remarks with a summary and conclusions of the reports.

<u>The Report on the World Bank's Strategy in Debtor Countries</u>

As required by H.R. 4645, we have carefully reviewed the World Bank's role in debtor countries. In our judgment, one of the World Bank's most vital functions in these countries is to promote sound economic reform programs through its adjustment programs and to catalyze additional financial support. Various Bank programs designed to achieve these twin goals are outlined in the report.

While we call upon the Bank to increase its efforts to return borrowers to the growth path, we recognize that sustained growth in many countries has been elusive; aggregate data for 17 heavily indebted nations are included in the report which support these findings. This is not to say that the "Baker Plan" has been a failure -- far from it. The review of the debt strategy has reaffirmed the effectiveness of a case-by-case approach which emphasizes growth and debtor country reform. Highlighted in the report are achievements of the past four years, including improved export performance; sustained adjustment efforts of several major debtors, including Chile, Colombia, Mexico, Morocco and the Philippines; and declines in the stock of debt through voluntary, market-based techniques.

However, further progress on adjustment programs will require the release of additional financial resources as well as an easing of debt service burdens in order bring about sustained growth. It is recognized that the debt strategy needs to be strengthened especially in this area. In addition to new lending, negotiated reductions in debt and debt service burdens can provide important external financial support. Other non-debt creating methods, which we continue to strongly advocate, are direct and portfolio investment, debt/equity swaps, and, importantly, the return of flight capital.

We strongly believe that the international financial institutions should retain central roles in the debt work-out process. This will help win the confidence of the creditor community, and nurture a market-place where both debt reduction and new money can be negotiated in parallel. But we must also preserve the financial integrity of these institutions, and minimize risk to creditor governments and taxpayers.

By discussing several of our new ideas for facilitating debt reduction, the report directly addresses Congressional interest in expanding the World Bank's role in debt reduction. The report summarizes our ideas on possible initiatives in this area. I would underscore, at this juncture, that such funds would be available only for those countries undertaking adjustment programs, and individual transactions would be negotiated between debtors and commercial creditors.

In short, after careful analysis and review, we have come to conclusions somewhat parallel to the intent of legislators as expressed in H.R. 4645. Additional financial resources and an easing of debt service burdens can strengthen and sustain debtor nations' commitment to economic adjustment programs.

The Report on Special Purpose Allocation of SDRs

Pursuant to the 1988 Trade Act, we have studied the feasibility of a special purpose allocation by the IMF of Special Drawing Rights (SDRs) to the poorest countries for use in repaying their debt to foreign governments and international financial institutions. The report concludes that the use of SDRs would undermine adjustment incentives, contribute to inflationary pressures, weaken the liquidity of the SDR and its usefulness as a monetary asset, and undermine the ability of the United States to mobilize its SDR holdings.

The report determined that the IMF's Enhanced Structural Adjustment Facility (ESAF) is a preferred alternative for helping the poorest countries. It suggests that the Administration's request for a $150 million contribution to the ESAF represents a more effective means of providing U.S. support for efforts to deal with the balance of payments and debt problems of the poorest countries.

International Discussions on an International Debt Management Authority

Turning to the report on the negotiation of an International Debt Management Authority as required by the 1988 trade legislation, the Treasury Department has reviewed many international debt facility proposals. Most of these proposals have several common elements, including a significant, up-front injection of capital and the assumption of full risk on principal and interest.

As required by law, we fully examined possible use of IMF gold stocks or World Bank liquid assets, but determined that such measures would face significant obstacles. I refer you to the detailed analysis at the end of the report.

Our assessment concluded that negotiation of an Authority at this point could materially increase the likelihood of payment interruptions and a further decline in secondary market prices. We believe that the suggested, market-oriented approach outlined by Secretary Brady on March 10 addresses Congressional concerns with less risk to taxpayers.

Voluntary debt reduction techniques have already been developed by the commercial banks and debtor countries in response to both the banks' strategies and goals, and debtor nations' appetite for capturing the discount on their debt. Voluntary, market-driven debt reduction operations since 1985 now add up to an estimated $28 billion.

Strengthening the Debt Strategy

The debt difficulties of developing countries remain a serious global problem which requires cooperative efforts on the part of all parties. Following a thorough review of the current approach by the Administration, Secretary Brady has recently outlined suggestions for strengthening the international debt strategy. Our suggested approach builds upon the basic principles that have guided international efforts in recent years. It recognizes the continued vital importance of stronger growth, debtor reforms, external financial support, and a case-by-case approach to individual nations' problems.

Our suggestions would maintain a central role for the IMF and World Bank within the debt strategy in encouraging debtor policy reforms and catalyzing financial support, and recognize the continuing need for new lending from commercial banks. However, we would also place stronger emphasis on new investment flows and the repatriation of flight capital as alternative sources of private capital. To this end, we would encourage the IMF and World Bank to work with debtor nations to focus on specific measures to improve the investment climate and encourage the return of flight capital as part of their policy-based loan programs, in addition to vital macroeconomic and structural reforms.

In addition, we would focus international efforts on achieving more rapid and broadly based, voluntary debt reduction during the next three years in order to ease debt burdens and improve prospects for stronger growth. One of the key factors at play in determining the extent of voluntary debt reduction activity is the legal constraints within existing commercial bank agreements, which must be waived by most or all commercial bank participants for each individual debt reduction transaction. Debt/equity swaps and sales in the secondary market are exceptions, but there is a strong interest within debtor nations in obtaining more direct benefits from commercial banks' willingness to reduce their own exposure -- as can be obtained through debt/bond exchanges or cash buybacks.

A waiver of such provisions as sharing and negative pledge clauses in existing commercial bank loan agreements could go far to free up market activity in this area, and to accelerate the pace of debt and debt service reduction with direct benefits to debtor nations. Such waivers might have a limited life of perhaps three years, to stimulate activity within a short but measurable time frame.

In addition, an integral part of the approach would be for debtor nations engaged in debt reduction to maintain viable debt/equity swap programs, which have helped to substantially reduce the stock of debt in several countries. Provisions which permit domestic nationals to engage in such transactions can also contribute to the repatriation of flight capital, as we have seen in the case of Chile.

As debtor nations negotiate policy-based loan programs with the IMF and the World Bank, a portion of these loans would be set aside to finance debt reduction transactions negotiated between the debtor and the banks. Such "set-aside" amounts would be used to collateralize discounted debt/bond exchange transactions or to replenish debtor reserves following cash buybacks.

For debtor nations which have negotiated agreements to reduce the stock of debt, the IMF and World Bank could also make available support for interest payments on a rolling basis for a limited period. Such support could be available for transactions which involve either a substantial discount of principal or a major reduction in interest rates.

While the IMF and World Bank would set guidelines on how their funds are used, the negotiation of transactions would remain in the market place -- encouraged and supported but not managed by the international institutions.

Such transactions could lead to considerable improvements in the cash flow positions of the debtor countries, reducing their need for external financial support to more manageable levels. Nevertheless, new lending would still be needed -- in addition to efforts to repatriate flight capital and attract new investment. Such new financing could include a range of special purpose loans such as trade credits and project loans, as well as club loans by a group of banks or continued concerted lending in individual cases.

As part of this approach, creditor governments should also continue to reschedule or restructure their own exposure through the Paris Club, and to maintain export credit cover for countries with sound reform programs. In addition, creditor countries which are in a position to provide additional financing in support of this effort may wish to consider doing so. This could contribute significantly to the overall success of this effort. We believe that creditor governments should also review their regulatory, accounting, and tax regimes with a view to removing impediments to debt reduction, where these exist.

Broad international support is critical to strengthening the current strategy. It will require cooperative efforts by creditor and debtor governments, the commercial banking community, and the international financial institutions. We have consulted closely with these groups and have sought suggestions from Members of Congress prior to developing the ideas introduced last week by Secretary Brady. The Japanese have expressed their strong support, including a willingness to provide supportive financing, and a number of other creditor and debtor nations have made favorable responses to the general approach we have outlined.

Conclusion

Taken together, the ideas I have discussed today represent a basis on which we can work together to revitalize the current debt strategy. We must address key problems -- the restoration of private financial flows, the return flight capital, the need for sustained economic reforms in many countries, and preservation of the financial soundness of the multilateral institutions -- if we are to renew progress in addressing international debt problems.

We believe that through the suggestions we have outlined, including efforts to stimulate broader voluntary debt and debt service reduction, substantial benefits can be provided for debtor nations in the form of more manageable debt service obligations, smaller and more realistic financing needs, stronger economic growth, and higher standards of living for their people.

I look forward to consultations with members of Congress in the weeks and months ahead, and ask you for your support as we develop within the international community a more specific agenda for further action. Thank you.

BOCK

MH

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDENCE DATE : 89/04/21 DUE DATE : 00/00/00
LOG NUMBER : 890421006 FROM : David Bock
SUBJECT : Revised Board Memorandum on Brady Implications.

OFFICE ASSIGNED TO FOR ACTION : Mr. B. Conable (E-1227)

ACTION:

______ APPROVED
______ PLEASE HANDLE
______ FOR YOUR INFORMATION Comments
__✓__ FOR YOUR REVIEW AND ~~RECOMMENDATION~~.
______ FOR THE FILES
______ PLEASE DISCUSS WITH __________
______ PLEASE PREPARE RESPONSE FOR __________ SIGNATURE
______ AS WE DISCUSSED
______ RETURN TO __________

COMMENTS :

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE April 21, 1989

TO Distribution

FROM David R. Bock, Director, DFS

EXTENSION 72942

SUBJECT Revised Board Memorandum on Brady Implications

1. Attached is the revised version of the paper for the Board on the Operational and Financial Implications of the Brady Proposals. The paper has been revised in light of the discussion on Wednesday plus other comments received separately from Mr. Qureshi and others. The general tone of the paper is now more "operational" with a conclusions section at the end rather than the earlier list of issues. Sections III and IV have been almost completely rewritten; the others less so but are nonetheless extensively changed.

2. Our expectation is that the paper will be circulated to the Board on Monday, assuming any needed changes can be incorporated over the weekend. The earlier draft had been given to the Fund on an informal basis and preliminary comments from ETR staff have been incorporated in this draft. However, the paper is only now being formally circulated to the Fund for comment, with a request for response by Monday noon. We do not anticipate any major problems with the Fund, based on the extensive discussion that we have already had on the key issues.

3. There has not been adequate time to fully coordinate this paper with the "Analytics" paper being prepared by PPR, but we believe there are no major inconsistencies, again based on extensive discussion along the way.

Attachment

cc: Messrs. I. Husain, Steer, Scott, Shilling, Toft
Holsen, Dubey, Shakow, Stanton, Ms. Haug

Distribution:

Messrs. Conable, Qureshi, Stern, Fischer, Shihata, Wood

P-1866

CP

DRAFT
04/21/89

BOARD MEMORANDUM ON

OPERATIONAL IMPLICATIONS OF DEBT REDUCTION PROPOSALS

I. Introduction

1. Over the past year, former Finance Minister Miyazawa of Japan, President Mitterand of France, and most recently Secretary Brady of the United States have made proposals to include debt and debt service reduction more formally in the debt strategy and to promote some form of official support for such action. The April meetings of the Interim and Development Committees agreed that it would be appropriate for the World Bank and the IMF to provide resources to assist members undertake debt and debt service reduction. These Committees further indicated that the policy issues and specific modalities of such support should be considered by the respective Boards of the two institutions. In addition, during the discussion of the Memorandum on the "World Bank's Operational Strategy in Heavily Indebted Middle Income Countries" a number of Directors asked for further analysis of these issues.[1]

2. The purpose of this memorandum is to outline for discussion and review by the Executive Directors the key operational and financial issues relating to debt and debt service along the lines discussed in the Interim Committee communique. A companion paper is being presented which addresses the analytic issues related to debt and debt service reduction[2] [reference when available]. These two papers are intended to elicit guidance from Executive Directors on the principles that should guide the Bank's actions in debt and debt service operations in specific countries, the first of which are likely to come to the Board's attention in the very near future.

3. Secretary Brady's proposal represents a particularly important step forward in achieving a consensus on the role of debt reduction, and the specific elements of his proposal perhaps provide a convenient (though by no means exclusive) framework for discussing how the Bank should seek to develop a role in debt and debt service reduction. More specifically, under

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1/ Memorandum (R-89-21, February 17, 1989) discussed on March 14, 1989.

2/ Debt reduction is used here to mean reduction in the outstanding principal, while debt service reduction is used for reductions in the amount of interest payments compared to the original instrument. From an economic view point, both result in a permanent reduction in the present value of claims on the debtor, and to a first approximation equiproportional reductions in either principal or interest result in about the same reduction in the present value of the claim, although the payments flows may differ. In some circumstances, debt reduction refers to either or both mechanisms.

the Brady framework a portion (say 25%) of the funds currently allocated by the Bank for quick disbursing adjustment operations in heavily indebted countries would be "set aside" to support debt reduction operations. A similar portion of expected IMF programs was also proposed to be "set aside" for this purpose. Such support would, of course, only be offered if the debtor were pursuing a strong adjustment program. Most heavily indebted countries will require waivers of sharing, prepayment, and negative pledge clauses to allow these operations to take place, and a time-limited waiver of these clauses was suggested.

4. Additional funds from the Bank, the Fund, other donors, and possibly from the debtors' own resources would be used to support interest payment reductions in some fashion. Interest support would be limited to coverage of one or two years of interest payment, which may be allowed to roll forward if not called.[3] Measures should also be taken to encourage more direct foreign investment and capital repatriation.

5. The form and amount of debt reduction is expected to be negotiated directly between the debtor and the commercial banks, subject to prior understandings with the Bank and Fund concerning the amount and timing of resources that would be available and the benefits in terms of debt and debt service reduction that would be expected. The overall debt reduction parameters and the approximate mix of modalities would be estimated in the context of a medium term program financing plan acceptable to the Bank and the Fund.

6. The announcement of the potential availability of debt or debt service reduction has already raised expectations. While the value of this goal cannot be denied, it remains to be determined how far the resources now identified can go in resolving the debt problem using market based operations.[4] Rapid response is necessary in order not to add still further to the uncertainty that has been created by these proposals. It is also important that the response of the Bank be carefully structured to assure a significant impact on the development prospects of the participating countries and to protect the integrity and credit standing of the Bank itself, so that it can continue to provide development assistance to all eligible borrowers over the long run.

3/ In the wake of these proposals, a wide variety of options are being studied in the Bank and elsewhere, and this work will better inform the decisions when individual cases are addressed.

4/ In general, market based operations would be evaluated by commercial banks in terms of their risk adjusted discounted present value, compared to the market value of holding the existing asset. In cases where obtaining sufficient debt relief in this manner is not feasible (perhaps too costly), renegotiation of existing assets with some modest enhancement may be possible with appropriate regulatory support, (e.g. application of FASB15 rules in the U.S.).

7. This paper addresses four main issues concerning the Bank's support of debt and debt service reduction schemes;

- Which countries should be eligible for Bank support of debt and debt service reduction operations?

- To what extent should Bank resources be devoted to debt and debt service reduction operations, would this limit or constrain the Bank's ability to implement currently planned lending to other borrowers, and what exposure risks would be entailed by provided support for debt and debt service reduction on the scale envisonned?

- What modalities of debt reduction and credit enhancement should be used, and how should Bank support be allocated among them?

- What should be the Bank's operational relations with other creditors to implement debt and debt service reduction actions?

Each of these questions will be addressed in a separate section below.

II. Country Eligibility

8. Authority for the Bank to lend for debt and debt service reduction operations would fall under the "special exceptions" conditions for lending in a manner similar to the justification for structural adjustment lending.[5] As such, it must meet the stated criteria of materiality and offer a significant enhancement of the recipient country's development prospects. In this context, there would have to be a material contribution to country's prospects to increase growth or expand productive investment resulting from the Bank participation in the reduction of the debt burden for such an operation to be justified. In addition, to the extent possible, the Bank's normal economic evaluation criteria would have to be satisfied.[6] From this it follows that financial support from the Bank for arrangements to reduce debt or debt service should only be provided if certain conditions are met. The most important would include (i) the adequacy of the country's medium term adjustment program, (ii) the need for debt and debt service reductions in order to design a viable medium term external financing plan consistent with the adjustment program, and (iii) the contribution of the resources resulting from debt and debt service reductions to enhancing the country growth and development prospects, primarily by increasing investment.

9. The Medium Term Adjustment Program. Our current analyses indicate that satisfactory resolution of the debt overhang and reform of the underlying economic distortions and disequilibria will take several years at least, even with significant debt and debt service reduction. In view of this, a satisfactory medium term adjustment program acceptable to both the Bank and the IMF is essential.[7] There must be a reasonable expectation that the implementation of this program will result in growth and adjustment over the period concerned and both eliminate the country's dependence on external finance of public deficits and eventually bring the country significantly closer to normal access to credit markets for truly voluntary trade and project financing.[8] This expectation must be based upon satisfactory understandings regarding the macroeconomic framework, the

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5/ See Mr. Shihata's memo of April --, 1988 (Board Reference) for a full discussion of this issue.

6/ For most debt reduction operations such as a buyback, it is possible to calculate a rate of return, for example, with a buyback where there is relatively low discount, say less than 30%, the rate of return would not meet normal Bank standards. This would preclude Bank support of such operations.

7/ The first two to three years of which would normally be fully specified within a satisfactory overall medium term (5-6 year) framework.

8/ This implies that countries should not count on significant amounts of new money for budget or balance of payments support if they are also engaging in large scale debt reduction.

credibility of the government's willingness and ability to undertake the policy and institutional reforms in the adjustment programs, and the availability of the external financing expected, including reductions in debt and debt service, new money disbursements, and rescheduling. To the extent an increased or "front loaded" disbursement pattern is required for debt and debt service reduction, a strong track record of implementation of adjustment measures would be expected as evidence of the government's commitment and capacity in order to justify the added risk to the Bank of these extraordinary measures.

10. Because of the extraordinary nature of these debt and debt service operations, the sustainability of the scenario and related adjustment programs is vitally important. In considering sustainability, attention must be given to the need to maintain acceptable levels of consumption, especially of the most vulnerable groups, and to provide the resources necessary for investment and renewed growth. Particular attention must also be given to policies that discourage capital flight, encourage the return of capital now held abroad, and establish an environment that promotes direct foreign investments. Debtor countries need to sustain relations with their commercial banks, and the medium term adjustment programs and the financing plan should be designed accordingly. Consequently, a willingness to undertake serious negotiations with creditor institutions will be viewed as an important element in the country's commitment to its adjustment program.

11. The Need for Debt Reduction. In general, debt or debt service reduction, as distinct from obtaining additional resources through increases in debt, may be necessary when as a country's debt burden is so large that servicing it would seriously impair, if not prevent, the country from attaining satisfactory growth rates. Moreover, access to capital markets may be so constrained that new loans are simply not available in the amounts necessary to fund a financing plan for orderly, growth oriented adjustment. Where debt or debt service reduction is deemed to be an essential part of a financial plan supporting a satisfactory adjustment program, this may provide justification for the Bank to finance such arrangements, providing that the potential benefit can be estimated to have a material impact upon the prospects for growth oriented adjustment, compared with alternative uses of these resources. These considerations imply that debt reduction will be supported by the Bank only if the discount or service reduction involved is consistent with what is judged necessary to produce a viable external financing plan for the adjustment program. Since the relevant circumstances differ greatly between countries, a case-by-case approach is necessary.

12. Contribution to Growth Potential. The arrangements for the reduction of debt and debt service to be supported by the Bank will concern public and publicly guaranteed debts outstanding to commercial banks. The resulting reductions in debt service obligations must add, in a clear and significant way, to the resources which are available and devoted to

productive uses, primarily investment, as defined in the Articles.[9] The concept of investment may be broadly defined to include development expenditures, i.e., not only fixed investment by the public sector, but also including investment in human capital (particularly expenditures for nutrition, health and education), and the maintenance of economic and social infrastructure.

13. These criteria turn out to be fairly restrictive, resulting from Management's concern that use of funds for debt and debt service reduction meet the materiality criteria and are the most productive use of Bank resources. In the early stages of this new activity it would be unwise to risk unduely the credibility or the credit standing of the institution in support of operations that do not have a high probability of success and a significantly favorable impact on the debtor country's prospects. As a consequence, only half a dozen countries are likely to qualify in the next year, countries which have credible and strong adjustment programs and whose debt is traded at a sufficient discount to offer real benefit from debt and debt service reduction operations.[10]

14. For those countries who have yet to put in place a sustained and viable adjustment program, the possibility of obtaining support for debt and debt service reduction from the international financial institutions should provide an added incentive to put such a program in place. For those countries whose adjustment efforts have been so strong that there is no opportunity to gain from market based debt reduction (i.e. their debt trades at or near par), this program unfortunately has little to offer. These countries, however, have benefited directly from much stronger growth of their economies and from continued access to commercial credit.[11] They are in far better shape than the countries whose debt trades are at steep discounts. Despite simplistic political pressures that may arise on occasion in those countries to try to arrange to drive down the price of their debt, the costs of such actions would far outweigh any possible benefits. These countries need to retain their access to commercial markets, and the Bank is currently proposing other initiatives to enhance these countries' access to credit.[12]

15. This initiative does not address official debt relief, which is the province of Paris Club, nor use of IDA resources to support reduction

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9/ See Mr. Shihata's memo of April --, 1989 (Board Reference) for a full discussion of this issue.

10/ For this reason, no list of countries is proposed in order not to raise expectations nor to create an impression of entitlement.

11/ Some have also benefited from substantial amounts of concessional assistance, which has helped ease the debt service burden.

12/ See for example "IBRD Role in FInancial Intermediation Services: Expanded Cofinancing Operations", R-89-37, March 13, 1989.

of commercial debt or debt service to low income countries. (The possibility of IDA using some IDA resources in this manner has been raised in the IDA negotiations, and management will keep Directors informed as to the progress of these discussions.)

III. Potential Resources Allocation and Exposure Issues

16. World Bank resources to support debt and debt service reduction could be made available from two sources. In the first instance, a portion of the Bank's ongoing lending program in each participating country could be set aside for the purpose. Second, where the adjustment program justifies a larger response by the Bank, additional funds could be allocated to participating countries over and above the programmed lending level. This section discusses the potential impacts of these approaches on the Bank's resource position, as well as their exposure and risk implications.

17. Potential Impact on IBRD Resource Position. In contrast to the situation in the IMF, there are no access limits to guide the volume of support provided by the Bank to individual borrowing countries. The scale of Bank lending depends upon individual country circumstances, including the depth and breadth of adjustment programs for which the country seeks bank support, the magnitude of the overall financing requirements, the contributions that can be reasonably be expected from other creditors, and the Bank's own guidelines on acceptable levels of exposure.

18. In assessing the potential impact of the pending proposals, it has been assumed that approximately 25% of the adjustment lending envisaged for the "high case" in individual heavily indebted countries could be set aside for debt reduction purposes. This amounts to approximately 10% of the overall "high case" lending program in these countries. Since the set aside resources would substitute for adjustment loans which are assumed to be fast-disbursing, the resources impact on the Bank of this part of the proposals would be minimal.[13] To the extent the availability of Bank and Fund support for debt reduction encourages more countries to adopt or pursue comprehensive adjustment efforts, the impact would be equivalent to a slight acceleration of the Bank's overall lending program as compared to the "base case".

19. If, however, the Bank were to provide resources in addition to the set aside, this would have both resource and exposure implications. For purposes of analysis, we have assumed that additional resources equivalent to about 15% of "high case" lending plans might be provided to catalyze financing packages involving substantial debt or debt service reduction. The form this support might take (e.g. support of interest; escrow accounts vs. guarantees) is considered in the following Section.

20. The resource consequences of additional commitments would obviously depend upon how many heavily indebted countries adopt programs that meet the eligibility tests outlined in Section II. Our calculation indicate that additional support could in theory reach $2 billion per annum

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13/ The country would, however, need to find alternate sources of finance for the imports that would have been financed by the "set aside".

(or $6 billion for three years) based on the 15% assumption. Experience, however, suggests that actual support would probably be considerably less. Nevertheless, even if additional support were to be $2 billion per annum, this would not create serious resource pressures for the Bank either in terms of lending authority (the sustainable level of lending) or in terms of borrowing capacity, provided that the additional support is defined as a temporary expansion of a country's lending program.

21. With respect to lending authority, the GCI which is now being subscribed should raise the sustainable level of lending to about $22.5 billion. This should comfortably suffice to cover the Bank's level of activity over the next three years, even with additional support on the scale described. The temporary character of the program is very important to this conclusion, however, and one of the major risks is that it will in practice prove difficult to enforce the intended temporary character.

22. On the borrowing side, the resource implications depend on the form of support provided by the Bank. If this support takes the form of loans (e.g. into escrow accounts), then additional Bank borrowing of something on the order of $3 to $4 billion could be required over the next three fiscal years. This amounts to roughly 10% of the borrowings currently planned and would appear to pose no serious problems either in terms of volume or cost. If the form of support were guarantees, the borrowing implications could be less, depending on the extent to which potential calls on the guarantees would be covered in advance through increases in Bank liquid holdings.

23. <u>Exposure and Risk Concerns</u>. The provision of additional funds above and beyond the current "high case" program would result in additional exposure to heavily indebted countries. Preliminary calculations suggest that if participation were to include most of the heavily indebted countries, the annual share of total Bank net disbursements allocated to the these countries could reach around 60% over the next three years, in comparison with slightly less than 50% in the absence of the scheme. As stated above, it is unlikely all these countries would meet the eligibility condition over the coming three years.

24. In assessing the creditworthiness of a borrowing country, Bank staff analyze the ability and willingness of the borrower to service its debt to all creditors in general, and its debt to the IBRD in particular. A debt reduction program can be expected to receive Bank support only if it promises to improve a debtor country's ability to service both the IBRD and all of its other creditors. However, there are risks associated with such a strategy that will need to be carefully managed.

25. The most important concern derives from the dilution of preferred creditor debt. The Bank currently faces a low risk of payment arrears because it holds a relatively small share of the outstanding debt in each of the high debt countries. These Bank loans receive preferred repayment treatment because of the Bank's special relations with the country. Debt obligations to preferred creditors (especially the Bank and the Fund) would

rise in both absolute and relative terms under debt reduction transactions. Preliminary estimates indicate that for the average country which participates in the scheme, the share of preferred creditor debt service in total public debt service may rise from 25% to 30% over the next three years. While this in itself is not an exceptionally large increase, there could be, in addition, a potentially large new stock of "secured" debt, whose service would be officially enhanced, depending on the type of debt reduction operations undertaken. Debt service on this new secured or "quasi preferred" debt may account for an additional 15-25% of total public debt service.[14]

26. This expansion of preferred creditor debt may in turn reduce the flexibility in the country's debt structure and could pose risks to the Bank unless there is a reasonable assurance that external financing will be available on suitable terms and in adequate volume to meet the country's minimum requirements. The inherent uncertainty of macroeconomic forecasts underlines the importance of maintaining flexibility in the structure of debt. If too large a proportion of a country's debt service is preferred or partially secured, an adverse shock (external or internal) is more likely to affect the country's ability to service its preferred creditors. The risk is less if there is a "cushion" of more easily restructurable debt that can absorb the consequences of unforeseen debt servicing problems. This suggests that it will generally be preferable from a risk management standpoint to achieve debt service reduction through transactions which encourage larger discounts and provide secured status to a smaller portion of the total debt, than those which result in smaller discounts with larger volumes of old debt participating and receiving "quasi preferred status".

27. In cases of very comprehensive debt or debt service reduction, the Bank would be prepared from a risk management standpoint to consider supporting operations which result in relatively greater rigidity of the remaining debt stock, if there were adequate assurances of the country's repayment capacity.[15] The possibility of unforeseen adverse shocks also indicates that the official sector and/or the debtor need to identify sufficient contingent resources (the CCFF in the IMF or the country's official reserves) to provide support in the event of such shocks.

14/ Debt buyback would directly increase the level and share of international financial institution held debt in the total. Debt reductions with enhancement would increase the portion of "quasi preferred" debt and may also increase the share of official debt if the enhancement is provided through direct loans. See further in Section IV below.

15/ This would depend on the judgements on the criteria outlined in Section II.

IV. Modalities of Bank Support

28. The question of how the Bank should support debt and debt service reduction involves three closely related issues: first, the role that official resources in general should play in supporting interest payments (as opposed to simply financing reductions in the stock of outstanding debt); second, whether the so-called "set aside" funds should be exclusively devoted to reductions in debt stock with potential additional commitments directed largely or exclusively to interest support; and third, whether the Bank should make use of its guarantee powers for interest support or restrict its role in this area to making loans to the borrower to finance collateral that would be deposited in escrow or trust accounts. These issues have been frequently collapsed in the debate on official roles in debt and debt service reductions, in particular with respect to guarantees as the main form of support for interest payments, and it may be useful to address them sequentially notwithstanding their close interrelationships.

29. Interest Support. The perceived need for official support on interest payments arose largely as a result of the 1988 Mexican exchange offer. In that transaction, the Mexican authorities and their financial advisers constructed what amounted to a modified debt buyback in which the resources available for debt repurchase were applied, in effect, only to the principal amount of the debt. The collateralization technique employed left the interest payments unsecured. As a result, whether or not the transaction would achieve economic leverage vs. a simple cash buyback depended on tax and regulatory factors and -- perhaps more importantly -- on the value that the market would attach to the explicit exemption from new money calls and future restructuring that the Mexican authorities were prepared to grant to the new bonds.

30. In the end, the market appears to have attached only modest value to the new money exemption. Banks bidding for the bonds reportedly treated the unsecured cash flows on the bonds as undifferentiated Mexican risk, i.e., they did not believe that the bonds would have effective seniority over other UMS debt. This led to the general conclusion that successful "leverage" of resources available for debt buybacks would depend on finding a way to make the new money exemption have genuine value for the bondholders. Hence the interest in obtaining third party guarantees on interest payments--which put in place an explicit source of new money to take the place of the concerted financing obligations that might otherwise dog the heels of the bondholders--or in having the borrower put additional resources into an escrow account to cover (or prefund) a portion the interest payments--which would reduce pressure on bondholders to participate in future concerted financing arrangements aimed at avoiding a generalized payments default by the borrower.[16], [17]

16/ Another way of expressing the difference between escrows and guarantees is that the latter explicitly shifts potential new money calls to other creditors, the former only implicitly.

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31. Given the complications associated with exchange offers, however, and the fact that the economic effects of exchange offers and buybacks are essentially similar, why not simply focus whatever resources are available on cash buybacks? Partly, this is a matter of tax and regulatory treatment of exchange offers that may create gains that can be shared by debtors and creditors. It is also due to the need for debtors to concentrate as much of the economic benefit of debt buybacks on the near term cash flows -- something that certain types of exchange offers may enable them to do. Moreover, exchange offers may allow commercial banks to "deal with" a larger volume of their claims for any given use of capital and reserves, depending on the extent to which the exemption from new money can be made effective. Buybacks, on the other hand, concentrate any loss-taking by banks on a narrower amount of claims and spread the cashflow relief for borrowers over a longer period of time. These considerations have tended to focus market attention at the present time on so-called par swaps, i.e., exchanges of existing loans for new bonds on a 1-to-1 basis with a sharply reduced interest rate.

32. As noted above, however, the stretching of resources to cover a larger volume of debt has certain drawbacks from the standpoint of the official providers of interest support (or, for that matter, providers of funds to purchase collateral for the principal component). The counterpart to treating a larger amount of commercial bank claims is the creation of a larger volume of partially secured and difficult to restructure commercial debt. To the extent that the discount obtained by the borrower--either on principal or interest--is not sufficient to clearly obviate the need for additional concerted finance to meet the interest payments on the exchange offer, the end result would be to create at best an ambiguous situation with respect to burden-sharing among creditors, or worse, an effective exit for commercial banks at too favorable of terms.

33. Moreover, some part of the interest by banks in the par swap form of exchange offer may stem from a willingness to contemplate reduced rate lending as a substitute for the new money process generally, at least for some countries.[18] Although in some respects similar to a par swap, reduced rate loans are different in that their terms are not necessarily based on market valuations, they do not create a new instruments (i.e., bonds) and they may provide only temporary interest concessions linked to a periodic re-assessment of a borrower's needs for cash flow relief. Under this approach, banks remain engaged in the debt workout process rather than exiting, and they retain a significant portion of the potential value of their claims, at least provisionally. Most important, official credit

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17/ The value of the new money exemption is also heavily influenced by the scale and duration of the new money obligations being avoided (i.e., the proportion of interest payments being refinanced) and the tax and regulatory treatment of new money vs. various exit instruments.

18/ See the discussion of reduced rate loans in R89-21, page 36 et seq.

enhancement is either not necessary at all or would serve only the limited purpose of catalyzing an agreement among a majority of banks sufficient to make such an approach workable. The public-private burden sharing would thus take the form of sharp interest rate reductions by banks for an extended period--e.g., five years, thereafter rising back to market rates -- in exchange for official guarantees on the reduced payments and ongoing official financial support for the borrower's adjustment program, with the guarantees (on other interest support) falling away when the interest rate moves back towards market levels. Under certain circumstances, this approach might be clearly preferable for both the debtor country and for the official creditor community if it were to prove acceptable to banks. It would be unfortunate if official support for more "market-oriented" debt and debt service reduction were to foreclose this possibility by offering an attractive exit for banks that might otherwise be willing to negotiate a more comprehensive (albeit more temporary) arrangement with particular debtors.

34. By themselves, these considerations might lead one to the conclusion that the best use of official resources would be a simple binary outcome: funding for cash buybacks aimed at reducing the debt stock and interest support for more comprehensive debt restructurings that make clear at the outset how the financing of interest payments is to be handled. This is, however, too simplistic, and it will be necessary to maintain some flexibility on how official resources for debt and debt service reduction should be used. Several other conclusions might also be drawn:

First, there should be clear preference for "clean" and narrowly focussed buybacks as the instrument of choice as far as the providers of official resources are concerned. This reduces the problems of creating quasi-preferred debt, entanglement, subordination and the possibility of too cheap an exit for banks. This preference obviously has to be balanced against the specific needs of the debtor countries--especially for near term cash flow relief--and what is "doable" in the market.

Second, interest support needs to be applied in such a way that it results in deep discounts in principal or interest on a more limited amount of debt rather than shallow discounts on a broad mass of debt.

Third, the proportion of total debt to which such interest support would apply should be confined to a relatively small figure, at least initially, <u>unless</u> a reasonably comprehensive settlement along the lines outlined above can be achieved.

Fourth, special care should be taken in providing support for par swaps to ensure that it does not foreclose the option of the borrower negotiating a more comprehensive arrangement involving significant concessions by commercial creditors.

Finally, it should not prove difficult for the Bank to manage an interest support program, provided that the preceding guidelines are generally accepted (see further below on the guarantees vs. loans issue).

35. Use of "Set asides". The preceding line of argument also suggests that it would be advisable for the Bank to impart a bias in the use of the set-aside and other resources in the direction of reductions in the debt stock, at least initially. Also, given that it will be important to show tangible results from the use of bank resources for debt reduction, a focussed attack on the debt stock might generate a more transparent outcome even if it contributes rather less to cash flow relief in the near term. However, a rigid division between the so-called "set asides" and any additional commitments would be clearly artificial and may or may not fit with the needs of a particular country case. Provided that Directors agree that Bank resources should be used either for debt stock reduction or interest support, management is of the view that the specific division between the two purposes should be worked out on a case by case basis on the understanding that interest support would need to be linked to some form of principal reduction in each country case. The justification for additional commitments would not be specifically tied to the need for interest support but rather to the needs of the case and the prospects that additional resources could achieve significant additional reductions in debt and debt service.

36. Guarantees vs. loans. Bank support could be provided either through use of its guarantee powers (e.g., by guaranteeing one or more interest payments) or through various forms of lending (direct loans to fund collateral/escrow accounts or lines of credit). The appeal of guarantees is threefold: first, they are in some respects simpler administratively than loans in that they require less (or no) funding in advance, do not require waivers of negative pledge provisions, and avoid certain special steps needed to manage currency and interest rate risks associated with escrow accounts. Second, guarantees may provide a greater opportunity for the Bank to influence the terms on which debt reduction takes place, since it would be a direct party to the transaction. Third, to the extent that multiyear guarantees are non-accelerable, they may provide (very modest) leverage of Bank capital. Fourth, the beneficiaries of such guarantees may under certain circumstances attach a value to them greater than the nominal amount of capital committed by the Bank.

37. "Excess" market value might arise because of the different ongoing relationships vis a vis borrower of the bondholder and the Bank. The bondholder may be one individual bank with limited negotiating leverage in the event of payment arrears. The World Bank has a presumably large and growing lending program and enjoys preferred creditor treatment. Thus, borrowers will be reluctant to default on the guaranteed payment because it could jeopardize the relationship with the Bank. The extent of such an "umbrella" effect depends obviously on the amount of non-IBRD debt that is guaranteed relative to the size of the Bank's own portfolio and lending program and on the strength of the Bank's preferred creditor status in the

country. It also depends on the specific rights and obligations of the Bank under the guarantee contract and on the Bank's policies with respect to remedying calls on its guarantees, especially whether it is prepared to convert the guarantee into a loan when called or demand immediate payment. In any event, the potential extent of any such "excess" market value cannot easily be predicted in advance.

38. The major drawbacks of guarantees are the fact that they are more likely to be criticized as a "bank bailout" notwithstanding arguments to the contrary and that they carry potential "entanglement" with commercial creditors. Such entanglement could lead to a greater risk of default on the Bank itself depending on the circumstances under which the guarantee is called. Indeed, such entanglement is the counterpart to the potential "excess" market value that guarantees might generate. The tighter the linkages to other Bank lending and the more effective Bank action on behalf of the holder of the guaranteed bond, the greater the danger of jeopardizing the Bank's own preferred creditor status.

39. Direct loans to the borrower, with the proceeds being used to fund an escrow account, limit many of these concerns. The degree of entanglement here is also a function of the specific terms of the escrow arrangement (especially the extent to which the Bank as escrow administrator might be expected to enforce certain restrictive conditions attached to the escrow), but should be generally less than in the case of a guarantee. In any event, the expectations of the Bank would be less at the outset and the risk of default to the Bank should be no greater than on any other loan to the country. Also, such an approach could facilitate cooperation with the IMF and with other potential sources of funding for interest support.[19] Direct loans would need to be funded, however. Also, arrangements would need to be made to manage currency and interest risks, the borrower would be required to obtain waivers of negative pledge (including from the Bank) and the Bank will need to accept effective subordination with respect to the collateralized bonds.[20]

40. A variant of this approach would be lines of credit. This is similar to lending for an escrow account, except that the funds would only be disbursed if the country were unable to make interest payments under the terms of the line of credit. Since the Bank would have already committed

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19/ In the case of "mixed" support, the Bank might provide a backstop guarantee on the escrow account that would be called only once the escrow itself had been exhausted. Also, it may be that some sources of cofinancing would prefer to guarantee rather than lend into the escrow accounts.

20/ Consideration is also given to an approach that would have the Bank issue guarantees in the capacity as administrator of a trust fund created for that purpose. This approach may provide a way to further insulate the Bank's own balance sheet from entanglement and may circumvent the need for negative pledge waivers.

the line, it would not strictly be seen to be lending into a default situation, as might be the case under a guarantee. If the line is revolving, the repayment terms may be shorter than a normal loan, thus discouraging its use. It should be possible to draft the agreements on lines of credit to give them the same linkages, or lack thereof, as escrow accounts. However, if the country rather than a trustee were perceived to control disbursements, the security offered by the line of credit might be viewed as less solid by some creditors, thus somewhat reducing the "umbrella" effect. Depending on how the agreement is structured, negative pledge waivers may be required.

41. Ultimately, it is important to consider the context in which support is to be given. The extent of Bank support must be calibrated to the degree that its support will contribute to a substantial and lasting resolution of the external debt burdens of countries, which in turn promote more rapid development. Where guarantees, even with their associated entanglement, are judged to be critical to achieving a viable program, the gains may outweigh the risks, and such operations would be justified. For example, in a country needing only a large amount of cash flow relief over a limited time period, guarantees of significant interest payment reductions over that period may be the most efficient and appropriate instrument. With limited Bank resources, perhaps they would be the only instrument able to provide the required volume of service reduction in the period required.

42. However, for these countries where debt service reduction alone is not expected to offer a comprehensive solution to the country's debt burden, or where it is expected that the debt workout process will remain a prolonged and perhaps uncertain affair, less entangling forms of support may be preferable. The ability of the Bank in some circumstances to preserve flexibility in the future by avoiding excessive entanglements today will be important. The arms-length relationship established by loan arrangements would likely to be more appropriate in such cases.

43. Country circumstances, the extent of leverage and entanglement judged acceptable, and the availability of other resources from the IMF or third parties will all affect the type and extent of Bank involvement in debt and debt service operations. It is likely that lending operations will be the normal vehicle for these operations. However, in view of its possible merits, the use of guarantees should also be kept as a possibility in appropriate circumstances, especially for highly concessional rates of interest where the risk of default may be especially low and where the catalytic effect may be especially high.

V. Relations With Other Creditors

44. The negotiation of "conventional" rescheduling and new money packages has become increasingly difficult as commercial banks are better provisioned against their LDC exposure and less willing to raise their exposure in these countries. Secondary market transactions have changed and reduced the base for new money. These factors have reduced the flexibility of the conventional debt strategy and introduced significant delays in assembling adequate financing packages. These delays have in turn impeded the provision of support by the international financial institutions and, in consequence, the implementation of adjustment programs. Official support has often been retarded due to the "critical mass" guidelines which have governed the official approach to meeting financing requirements.[21] In response, the international institutions have been moved to reduce their adherence to this objective, and the IMF and the Bank have disbursed funds in some cases where a critical mass has not been in hand. However, these have so far been viewed as exceptions to a general rule. There is now reason to consider introducing further flexibility in this approach by more formal recognition of an approach whereby in certain circumstances, the international institutions would continue their adjustment lending without having all the financing for the gap in place.

45. The practice of the Bank in its own adjustment operations has been to exercise independent judgement for tranche release based on progress under the program and a satisfactory overall macroeconomic situation. The Bank has relied on the IMF to assure the consistency of the macro economic framework and the financing plan underlying adjustment operations. By its Articles and mandate, the Bank has a stronger interest in the longer term development and structural transformation of its members, and this orientation is reflected in our judgments on adjustment and other lending decisions.

46. In instances of lending for debt service reduction, even closer coordination would be called for between the Bank and the IMF to reach a consistent view on viable medium term adjustment programs and financing plans, particularly where lending for debt and debt service reduction would increase the risk to the institution through increased exposure or expansion of the share of preferred credit, as discussed in Section III. Particular caution would be called for where the financing plan involved debt or debt service reduction that had not yet been agreed with the commercial banks. If the adjustment program were moving on track, the international financial institutions would consider disbursing in such cases and countenance the debtor accumulating arrears to commercial banks.[22]

21/ The "critical mass" concept in debt restructuring countries heretofore has held that the vast majority of the financing had to be in place prior to the IMF approving its operation.

22/ The IMF may explore developing an approach whereby on a selective basis arrears which are within the limits of the expected debt and debt
Continued on next page

47. It is assumed that the prospects of substantial arrears would encourage the commercial banks to reach an agreement quicker, as there would be more pressure on them than on the country, in contrast to the critical mass approach, which gives the banks more leverage to hold up IMF disbursement. This approach is not without operational risks, however. Countries may assume greater license to run more disorderly arrears than those implied in the financing plan, thus undermining it. And commercial banks may eventually resist the pressure, leaving the international financial institutions and the country part way into an underfunded program, with the resulting pressure on the international institutions to increase their contributions. The Bank will have to exercise prudence and judgement to minimize these risks, to maintain an impartial stance in relation to both the debtor and its commercial creditors, and to assure that both reach an equitable arrangement.

48. Bank-Fund Relations. Close collaboration between the Bank and the Fund will be necessary at all stages in reaching a common understanding on the medium-term macroeconomic framework, the supporting financing plan, and the broad dimensions of the financing and debt or debt service reduction package to be negotiated between the country and its financial creditors. Furthermore, it would normally be the case that both institutions have operations in support of the country's adjustment program. While acknowledging the Fund's responsibilities for the overall macro economic framework, the medium term nature of the programs gives added importance to the sectoral and structural components of the adjustment programs. We would expect that the Fund would give full weight to concerns of the Bank that the macro policy adjustments be fully consistent with the longer term sectoral and structural objectives of the Bank's program. There would have to be coordination in the monitoring of the implementation of the program and of the judgement on the progress of the negotiations between the commercial creditors and the country. Differences in judgements on these matters would need to be resolved quickly along the lines set forth in the recent memorandum of understanding between the two institutions.

49. Coordination of tranche releases could be difficult because of the different approaches to tranching of the two institutions. In the Fund, the timing of tranche releases are normally at predetermined (quarterly, semi-annual) intervals against performance criteria agreed in advance. In the case of the Bank, the timing of tranche release is more uncertain, depending on the implementation of a preagreed set of actions. It is entirely possible that the release of a tranche of a Bank adjustment operation would occur at a time other than the regular program review undertaken by the Fund. Coordination of judgements on the implementation of the program and the progress of negotiations with commercial creditors may require extensive consultation, and adequate scope within existing

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Continued from previous page
service reduction operations foreseen within the financing plan are countenanced so long as the country is pursuing negotiations in good faith. This would be monitored within the Fund program.

arrangements for achieving full consultation and agreement between the institutions will have to be assured. The question of what happens if one institution believes a tranche should be released when the judgement of the other is to the contrary will require further discussion. This is another facet of the always delicate question of cross conditionality.

50. Tranching and Disbursement Linkages with Commercial Banks. As indicated above, the medium-term framework and financing plan for an adjustment program would outline the broad parameters of the financing package (debt reduction, interest reduction, new money) that would have be expected to be negotiated between the country and the banks. While individual banks would have flexibility in deciding which elements to take up, the aggregate sum of the individual bank decisions would have to be broadly consistent with the financing package for the viability of the medium-term scenario to be sustained. Bank support for the debt and debt service reduction actions would normally be provided as a component of a larger adjustment operation. [It might also be provided in a free standing operation. The latter would be easier to adapt to the disbursement requirements of a deal with the commercial banks, but would pose questions of conditionality vis a vis other adjustment operations already in our lending program. Depending on our country strategy and the overall adjustment program agreed with the country, Management would determine which approach would be preferable on a country by country basis.] The Bank's disbursement procedures might have to be modified or phased with commercial bank actions in a manner which would help to bring about the aggregate outcome posited in the financing plan.

Why

51. Should it appear that a much more advantageous deal can be struck if a relatively large debt or debt service reduction package is offered and if the Bank is confident of the country's commitment and ability to sustain its program, evidenced perhaps by strong prior actions, then the Bank would consider "front loading" the adjustment program, and its disbursements either by adjusting the tranching of an adjustment operation in the pipeline or by adding a specific debt or debt service reduction operation. In the case of a planned adjustment operation, most or all of the "first" tranche could be allocated to debt or debt service reduction rather than an equal portion in each tranche.[23] Flexibility will be important, and the structure of each operation would have to be designed to assure both that the maximum amount of debt or debt service reduction is obtained and that the integrity and monitorability of medium term the adjustment program is maintained.

23/ If there were a delay in negotiations, this could conceivably result in the "second" tranche being disbursed first, if its other conditions were met. If the negotiations were delayed for an extended period despite the best efforts of the debtor and if the debtor were adhering to its adjustment program, the Bank would retain the option of allowing the resources allocated to debt or debt service reduction to be used by the debtor for other productive purposes.

52. In the past, the Bank has taken an active role in helping countries mobilize new money packages from its commercial creditors. This catalytic role has relied on a variety of factors, including the Bank's own lending program, its policy of conditionality, disbursement linkages, and more formal cofinancing arrangements. The Bank has employed cofinancing techniques sparingly in the context of restructuring packages, and only when some explicit Bank financial support was seen as essential to bringing a new money agreement to closure. The Bank's commitment was restricted to an amount that was a small (roughly 5-10%) in relation to the overall new money being provided by commercial creditors.

53. With the shift in emphasis to accelerated debt and debt service reduction supported by World Bank funds, commercial banks and their sovereign debtors will need to reach new agreements among themselves as to the appropriate balance between new money and debt reduction. The Bank's catalytic role would be very complex if it were expected to simultaneously promote new money and debt reduction. As a result, it may be appropriate for the Bank to assume a conservative and impartial role in the new money process for countries where it may also be supporting debt reduction, leaving these countries and to their commercial bank creditors to determine the menu options with a minimum of direct involvement.

54. In our view, it is unlikely that countries which are engaging in extensive debt and debt service reduction activities would also be able to attract significant amounts of new money for general budget or balance of payments support purposes. This implies that the more comprehensive reduction packages would need to be designed so that any requirements for new capital inflows be kept within the envelope that could be expected from the official sector. Country adjustment programs would have to reduce substantially, if not eliminate, the reliance for net foreign resources over the adjustment period. As the reform program takes hold, more trade and eventually project related financing can be expected to be forthcoming to supplement official resources. Countries are at various points on a continuum of need for debt or debt service reduction, and eventually at one end emerge seeking more normal access to commercial credit.

55. Support for debt reduction can only be a temporary <u>modus operandi</u> for the Bank. From a broader standpoint, it is essential that the institution have available workable and effective tools to catalyze new money, for the countries that are now heavily indebted, but which are able to improve their creditworthiness through sound policies and appropriate external debt strategies. The Bank must stand ready to support their re-entry to voluntary capital markets. And, even now, while the Bank works to alleviate the debt burden of its heavily indebted member countries, it cannot ignore the developmental priorities of those of its borrowing members that do not require recourse to debt reduction. In many of those countries, improved creditworthiness, access to a broader range of financial markets, and sophisticated special purpose financing instruments are attainable and highly desirable objectives.

56. [In this latter regard, a proposal from the President for an expansion of the institution's commercial cofinancing program has been distributed,[24] but consideration of the paper has been deferred. Management believes that consideration of the initiative on Expanded Cofinancing Operations is now appropriate and intends to bring the proposal to the Board in the near future.]

24/ "IBRD Role in Financial Intermediation Services: Expanded Cofinancing Operations", R89-37, March 13, 1989.

VI. Conclusions and Issues

57. To sum up, Bank management is fully supportive of the increased emphasis on debt reduction on which a consensus has recently emerged among member governments. It is clear, however, that World Bank support for debt reduction can only be provided where it makes sense in specific country circumstances. That is, support for debt reduction transactions must represent appropriate and efficient use of Bank resources that contribute in a material way to an enhancement of the prospects for growth and development as well as the country's specific capacity to service its debt. Full resolution of the debt problem in many countries will require a number of years, and our expectations and use of resources will have to be adjusted accordingly. It is also important to recognize that the initial steps in this direction will be modest. The volume of resources that the Bank and the Fund can devote to debt reduction will not lead to a resolution of the debt overhang problem in most of the heavily indebted countries within a short period of time, and the Bank will need to continue careful management of risk exposure in these countries. Not all countries are likely to qualify for such support in the near term. [However, Management is considering bringing the first such operations to the Board by early FY90.]

58. In preparing operations in light of the above considerations, Management would envisage applying the criteria outlined in Section II requiring strong medium term adjustment programs, demonstrated government commitment, a material contribution to the country's growth prospects from reducing the debt burden, and an adequate medium term financing plan. Once a satisfactory medium term program is agreed, the support to be provided by the Bank would be allocated from existing lending programs, plus any additional amounts that would be justified by the comprehensiveness of the proposed debt reduction and the Bank's own prudential concerns about its risk and exposure, as discussed in Section III. This might be in the range of 10% up to 25% (where additional funds are justified) of a country's planned "high case" lending program; it would be useful to have Directors' views on this point.

59. The specific designs of the debt or debt service reduction schemes are, of course, not known at this time. As a consequence, it is likely that exercise of flexibility will be necessary in the use of its funds between debt stock reduction and interest support and between direct lending and guarantees, subject to the concerns expressed in Section IV. While there could be a preference for direct lending and debt reduction [buybacks] in cases of less comprehensive reduction of the debt burden, the Bank would probably want to retain the option to employ a wider variety of instruments if appropriate, particularly if a comprehensive resolution of the debt overhang were achieved. These decisions might best be handled on a case-by-case basis and be subject to periodic reviews.

60. In specific operations, the Bank would coordinate closely with the IMF in preparing the medium term adjustment programs to be supported by debt and debt service reduction operations. The Board's attention would be

drawn in particular to those cases when the Bank proposed to initiate or continue disbursements when negotiations had not been completed with commercial creditors and/or when arrears to them were rising. These situations might be monitored closely, as discussed in Section V. It is likely that in some cases, front loading or other modification in normal Bank disbursement procedures would be called for, and management would appreciate guidance from Directors whether the approached outlined in Section V to handle these issues would be satisfactory, and on the suggestion that the Bank maintain an impartial role vis a vis the negotiations between creditors and debtors and refrain from attempting to catalyze new money in cases where major emphasis is placed on debt or debt service reduction operations.

61. If this general approach is acceptable to Directors, the next step would be to proceed to prepare initial debt or debt service reduction operations. The first may be presented to the Board for discussion in [about three months]. At that point, it would be appropriate to seek further definition of a number of these issues on a case-by-case basis.

Record Removal Notice

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File Title	Barcode No.
Financial Files - Debt - Correspondence - Volume 1	1466051

Document Date	Document Type
Apr 18, 1989	Memorandum

Correspondents / Participants
To : Mr. Ibrahim F.I. Shihata, LEGVP
From : David R. Bock, DSF

Subject / Title
Your Paper Entitled " Guarantee of Interest Payments : Legal Requirements "

Exception No(s).

☐ 1 ☐ 2 ☐ 3 ☑ 4 ☐ 5 ☐ 6 ☐ 7 ☐ 8 ☐ 9 ☐ 10 A-C ☐ 10 D ☐ Prerogative to Restrict

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Chandra Kumar	Aug 5, 2014

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDENCE DATE : 89/04/18 DUE DATE : 00/00/00
LOG NUMBER : 890418020 FROM : David Bock (MAQ)
SUBJECT : Briefing: Operational Implications on Debt Reduction Proposals.

OFFICE ASSIGNED TO FOR ACTION : Mr. B. Conable (E-1227)

ACTION:

__________ APPROVED
__________ PLEASE HANDLE
__________ FOR YOUR INFORMATION
__________ FOR YOUR REVIEW AND RECOMMENDATION
__________ FOR THE FILES
__________ PLEASE DISCUSS WITH ____________________
__________ PLEASE PREPARE RESPONSE FOR _______________ SIGNATURE
__________ AS WE DISCUSSED
__________ RETURN TO ____________________

COMMENTS :copied to Marianne

FORM NO. 75
(6-83)

THE WORLD BANK/IFC

ROUTING SLIP	DATE: April 18, 1989

NAME	ROOM NO.
Mr. Conable	

	APPROPRIATE DISPOSITION		NOTE AND RETURN
	APPROVAL		NOTE AND SEND ON
	CLEARANCE		PER OUR CONVERSATION
	COMMENT		PER YOUR REQUEST
	FOR ACTION		PREPARE REPLY
	INFORMATION		RECOMMENDATION
	INITIAL		SIGNATURE
	NOTE AND FILE		**URGENT**

REMARKS: Attached is a draft of the paper on operational implications of the Brady Proposals. I have not had the opportunity to review it. However, I have been briefed on its contents and believe that it addresses the key issues for discussion at this stage.

I understand that a second note is being forwarded to you directly from Stan Fischer which I have not seen.

FROM:	ROOM NO.:	EXTENSION:
Moeen A. Qureshi	E1241	73665

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

Brock - Debt

1. Eligibility - Medium Term framework, discount return to growth

2. Exposure + Risk —
25 % increment we could carry
15-25 % Quasi-preferred debt.
Do we have specifics on these amounts?

Halo effect vs. entanglement
should not choose as crow account?

3. New Money (¶ 43)
No catalytic role? Will we go ahead if no satisfactory financing? ¶ 40
4. Don't we have to have a more active role in new money process?

26-32

P-1852

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: April 18, 1989

TO: Mr. Moeen A. Qureshi

FROM: David R. Bock

EXTENSION: 72942

SUBJECT: Operational Implications on Debt Reduction Proposals

1. Attached is a draft of the issues paper for the Board on operational implications of the Brady Proposals. An earlier draft was discussed by Messrs. Fischer, Shihata, Wood and myself last night. This version has been revised overnight and during the course of today by its principal authors (Messrs. Shilling, Dubey, Holsen, Steer and Toft). It has not been further reviewed by the Task Force.

2. I understand that Mr. Conable wishes to receive this tonight for preliminary discussion tomorrow at 11:00 A.M. Messrs. Fischer, Shihata, Wood and I have agreed to authorize the forwarding of this note to you and the President on the understanding that it will be further reviewed and further revised before circulation to the Board at the end of the week.

Attachment

cc: Messrs. Stern, Fischer, Shihata, Wood, Ms. Haug
Dubey, Holsen, Shakow, Shilling, I. Husain, Steer, Morais, Toft

April 18, 1989
Version 5

BOARD MEMORANDUM ON

OPERATIONAL IMPLICATIONS OF DEBT REDUCTION PROPOSALS

I. Introduction:

1. Following the initiative proposed by Secretary Brady on March 10, 1989, and other similar proposals by French and Japanese authorities, the April meetings of the Interim and Development Committees agreed that it would be appropriate for the World Bank and the IMF to provide resources to assist members undertake debt and debt service reduction. These Committees further indicated that the policy issues and specific modalities of such support should be considered by the respective Boards of the two institutions. The purpose of this memorandum is to outline for discussion and review by the Executive Directors the key operational issues relating to supporting debt and debt service along the lines proposed by Secretary Brady and others.[1]

2. A companion paper is being presented which analyzes the economic costs and benefits of different debt and debt service reduction instruments for the debtor and in the financial markets. These two papers are intended to provide a framework for guidance by Executive Directors on the principles that should guide the Bank's actions in debt and debt service operations in specific countries that are likely to come to the Board's attention in the very near future. The general structure of the debt reduction proposal and the key issues are outlined below.

3. There is a growing acceptance that for some countries, debt burdens are so great that conventional responses of rescheduling and new money are not sufficient and that explicit debt and debt service reduction is required in order to restore growth.[2] Support from the international financial

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1/ More analysis of issues related to the overall problem of heavily indebted countries is contained in the recent memorandum "World Bank Operational Strategy in the Heavily Indebted Middle Income Countries" (R-89-21, February 17, 1989).

2/ Debt reduction is used here to mean reduction in the outstanding principal, while dent service reduction is used for reductions in the amount of interest payments compared to the original instrument. From an economic point of view, both result in a permanent reduction in the present value of claims on the debtor, and to a first approximation equiproportional reductions in either principal or interest result in about the same reduction in the present value of the claim, although the payments flows may differ. In some circumstances, debt reduction refers to either mechanism.

institutions may be needed to facilitate this process. In particular, Secretary Brady proposed that on average about 25% of the funds currently allocated by the Bank for quick disbursing operations in heavily indebted countries be "set aside" to support debt reduction operations. A similar portion of expected IMF programs is also expected to be "set aside" for this purpose. Such support would, of course, only be offered in cases where the debtor were pursuing strong adjustment programs. Most heavily indebted countries will require waivers of sharing and negative pledge clauses to allow these operations to take place, and a general three year waiver of these clauses was proposed.

4. It was also proposed that some additional funds from unallocated capital in the Bank, from available resources in the Fund, from other donors, and from the debtors own resources be used to support interest payment reductions. This part of the proposal is less specific as to the amounts and sources of resources, and the modalities of intervention are left open pending further study, particularly in the case of guarantees.[3] Interest support would be limited to coverage of one or two years of interest payment, which may be allowed to roll forward if not used. There is wide agreement that additional burdens should not be transferred to the public sector and that measures should be taken to encourage more direct foreign investment and capital repatriation. It is likely that new money will also be required to meet the financing requirements of some countries, and the Brady proposal foresees that as debt burdens are reduced, these will be the basis for new lending from the commercial banks to provide the necessary resources.

5. The form and amount of debt reduction is expected to be negotiated directly between the debtor and the commercial banks, subject to prior understandings with the Bank and Fund concerning the amount and timing of resources that would be available and the benefits in terms of debt service reduction that would be expected. The overall debt reduction target and approximate mix of modalities would be structured in the context of a medium term program financing plan, and monitoring system jointly agreed with the Bank and Fund.

6. The announcement of the potential availability of debt or debt service reduction has already raised expectations among the governments of potential beneficiaries and their publics, spawned a range of reactions from cautious support to acute concern among the commercial banks, and created the hope that the debt problem can at last be solved. While no-one denies this goal, it remains to be determined whether the resources now identified will be sufficient to fully resolve the debt problem with market based

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3/ The Bank can write guarantees. The IMF cannot write guarantees directly on its own resources, by its Articles, but it can do so indirectly on the basis of funds deposited by the country into an account managed by the Fund. It is currently considering this option.

operations. [4] While rapid response is necessary, it is also important that the response of the Bank be carefully structured to assure a significant impact on the development prospects of the participating countries and to protect the integrity and credit standing of the Bank itself so the it can continue to provide development assistance to all eligible borrowers over the long run.

7. The Brady proposals raise four main issues for the Bank's support of debt and debt service reduction schemes;

- Which countries should be eligible for Bank support of debt and debt service reduction operations?
- What volume of Bank resources should be devoted to debt and debt service reduction operations from currently planned lending and what additional resources should be made available?
- What modalities of debt reduction and credit enhancement should be used and how should Bank support be allocated among them?
- What financial assurances and monitoring conditions should be applied in cases of debt and debt service reduction?

Each of these questions will be addressed in a separate section below.

II. Country Eligibility

8. Authority for the Bank to lend for debt and debt service reduction operations would fall under the same enabling provisions as structural adjustment lending. As such it is must meet the stated criteria of materiality and offer a significant enhancement of the recipient country's development prospects. See Mr. Shihata's opinion of April, 1988 on this subject. In this context, there would have to be a significant contribution to the reduction of the debt burden for such an operation to be justified, in addition to the Bank's normal economic evaluation involving rates of return, etc. From this is follows that financial support from the Bank for arrangements to reduce debt or debt service should only be provided if certain conditions are met. The most important would include (i) the adequacy of the country's medium term adjustment program, (ii) the need for, and potential contribution of, debt and debt service reductions in the medium term external financing plan for the

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4/ In general, market based operations would be evaluated by commercial banks in terms of their risk adjusted discounted present value, compared to the market value of holding the existing asset. In cases where obtaining sufficient debt relief in this manner is not feasible (perhaps too costly), below market deals may be possible if the value of holding the existing asset is adversely affected by, say, unfavorable regulatory treatment.

adjustment program, and (iii) the contribution of the resources resulting from debt and debt service reductions to enhancing the country growth and development prospects, primarily by increasing investment.

9. <u>The Medium Term Adjustment Program</u>: As a first condition for the Bank to provide financing in support of debt and debt service reduction, the debtor country should have a satisfactory medium term (normally five years) adjustment program which has been agreed by the Bank and the IMF. There must be a reasonable expectation that the implementation of this program will result in growth and adjustment over the period concerned and bring the country significantly closer to normal access to markets.[5] This expectation must be based upon satisfactory understandings regarding the macroeconomic framework for the period, the reforms of policies and institutions that will be undertaken by the government, and the external financing expected, including reductions in debt and debt service, new money disbursements, and rescheduling. In these circumstances, we would expect that Bank financial support would be provided, as in the past, through a series of adjustment loans, disbursements under which would depend upon both satisfactory progress in implementing the overall adjustment program and implementation of specific measures that are agreed to in connection with individual loans. As an additional element, some portion of these loans would be available for debt and debt service operations that meet the relevant materiality criteria.

10. In reviewing adjustment programs particular attention will be given to their viability and sustainability and to the realism of the financing plan. Bank supported debt or debt service reduction arrangements are extraordinary measures which, if they fail, result in a loss of credibility and make it even more difficult to succeed a second time. In considering sustainability, attention must be given to the need to maintain acceptable levels of consumption, especially of the most vulnerable groups, and to provide the resources necessary for investment and renewed growth. Particular attention must also be given to policies that discourage capital flight and encourage the return of capital now held abroad, and to the establishment of an environment that promotes direct foreign investments which strengthen technology, productivity, and exports as well as providing additional capital resources. There is a need to sustain relations between the developing country borrowers and their commercial bank creditors, and the medium term adjustment programs and the financing plan should be designed accordingly. Consequently, a willingness to undertake serious negotiations with creditor institutions along these lines will be viewed as an important element in the country's commitment to its adjustment program.

11. <u>The Need for Debt Reduction</u>: In general, debt or debt service reduction, as distinct from obtaining additional resources through increases in debt, may be necessary insofar as a country's debt burden is so large that servicing it would seriously impair, if not prevent, the

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5/ It is understood that for some countries, a longer adjustment period may be required.

country from attaining satisfactory growth rates. Moreover, access to new credit may be so constrained that new loans are simply not available in the amounts necessary to fund a financing plan for orderly, growth oriented adjustment. Given the size of the debt overhang for many countries, and the poor prospects for voluntary commercial bank loans as long as outstanding debt in selling at a discount, debt or debt service reduction is in many countries essential to improve the prospects for successful implementation of a growth oriented adjustment program.

12. Bank financing of debt and debt service reduction arrangements would be justified when the potential savings are large enough to have a significant impact on investment and other economic variables to have a material impact upon the prospects for growth oriented adjustment. Bank support of debt or debt service reduction actions is appropriate when a country has a satisfactory overall adjustment program, the prospects for success of the related financing plan are substantially enhanced by the debt or debt service reduction measures, and the individual arrangement supported represents a desirable and effective use of Bank resources. The use of Bank resources for debt or debt service reduction purposes will in all cases be compared with alternative uses of these same resources -- either for financing appropriate general imports or for sector and investment projects. These considerations imply that debt reduction will be supported by the Bank only if the discount or service reduction involved is consistent with what is judged necessary in the external financing plan to make a viable workout possible. Since the relevant circumstances differ greatly between countries, a case-by-case approach is necessary.

13. Contribution to Growth Potential. The arrangements for the reduction of debt and debt service to be supported by the Bank will concern public and publicly guaranteed debts outstanding to commercial banks. The resulting reductions in debt service obligations must add, in a clear and significant way, to the public sector resources which are available and devoted to productive uses, primarily investment. The concept of investment may be broadly to include development expenditures, i.e., not only fixed investment by the public sector, but also including investment in human capital (particularly expenditures for nutrition, health and education), the maintenance of economic and social infrastructure, and extension of credit to the private sector in support of expanded investment. Without this link, the justification for the use of Bank resources would be hard to make.

14. Rather than offering a list of countries eligible for debt or debt service reduction,[6] the proposed approach offers criteria for permitting any country with a satisfactory adjustment program and a feasible debt or debt service reduction scheme that produces significant benefits to use part of the Bank's adjustment lending for debt or debt service reduction,

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6/ Lists tend to be difficult to agree on and often create expectations or disillusionment beyond their utility. They have little additional utility other than identifying a group for analytic convenience.

plus additional resources that may be made available. This program would be open to any country which could benefit from a significant reduction in its commercial debt. Directors' comments on this approach to eligibility criteria are welcome.

III. Potential Resources Allocation and Exposure Issues

15. It has been suggested that World Bank resources to support debt and debt service reduction could be made available from two sources. In the first instance, a portion of the Bank's ongoing lending program in each participating country could be set aside for the purpose. Second, in some situations, additional funds could be allocated to participating countries over and above the programmed lending level. This section discusses the potential resources available and their exposure and risk implications. The related question of the extent to which funds should be earmarked for either principal or interest reduction is taken up in Section IV.

16. Potential IBRD Resources Available: The size of Bank lending to each of its borrowing members is not predictable with accuracy. It will depend upon individual country needs and policy progress. In addition, as noted in Section II, it is not yet clear which countries will participate in the proposed debt reduction program. Combined, these facts imply that it is not possible to state with precision the volume of IBRD funds available for debt reduction. Rough magnitudes can however be indicated. For example, for the group of 17 Highly Indebted Countries (HICs), which will no doubt account for the bulk of debt and debt service reduction, the Bank's management currently envisages an aggregate three-year lending program for FY90-92 in the range of $25-38 billion. Actual lending, and in particular adjustment lending, will depend on the extent to which individual countries' adjustment efforts are broadened and deepened. The share of the lending program allocated to support debt and debt service reduction would in turn depend upon the needs and opportunities in individual countries. Our current thinking suggests that a share of about 10% of the overall lending program in participating countries is broadly appropriate. This is likely to be equivalent to about 25-30% of adjustment lending in these countries.

17. According to the needs and opportunities in individual countries, the Bank may also be willing to expand the size of its overall lending to participating countries by, say, 15-20%, for the additional debt and debt service reduction support. Although this would represent an increment over currently programmed lending levels, the amounts envisaged would not have a significant impact upon the timing of any future capital increase, nor, more importantly, would they divert resources from ongoing lending programs to non-participating countries. There would, of course, be a temporary reduction in the Bank's headroom. Current estimates suggest that at the end of FY92 (the end of the three-year implementation period), the Bank's headroom would be about $55 billion instead of about $60 billion without

the scheme. As the additional loans are gradually repaid (or the guarantees gradually fall away), this reduced headroom would be restored. Since the program proposed is temporary, there would be minimal impact upon the Sustainable Level of Lending (SLL), so that the need for, and timing of, future capital increases would be unaffected.

18. To the extent that credit enhancement would be provided by loans, this would require adjustments in the Bank's borrowing program. However, the amounts envisaged are not expected to pose problems. To the extent that interest coverage is provided through guarantees, additional IBRD borrowing would not be required.

19. Exposure and Risk Concerns: To the extent that funds are provided out of the existing program, the Bank's exposure would not increase beyond what it would have been under traditional adjustment lending. The normal assurances would, of course, be required that such exposure be within prudent limits. The provision of additional funds above and beyond the current program would result in additional exposure to heavily indebted countries. Preliminary calculations suggest that the annual share of total Bank net disbursements allocated to the Heavily Indebted Countries could reach around 60% over the next three years, in comparison with slightly less than 50% in the absence of the scheme. It will therefore be necessary for the Bank to assure itself that the improvements in creditworthiness stemming from the debt reduction outweigh any additional risks stemming from increased exposure in the high debt countries.

20. In assessing the vulnerability of the Bank's assets in a borrowing country, Bank staff analyze the ability of the borrower to service its debt to all creditors in general, and its debt to the IBRD in particular. A well-implemented debt reduction program can be expected to improve a debtor country's ability to service both the IBRD and all of its other creditors. However, there are risks associated with such a strategy that will need to be carefully managed.

21. The most important concern derives from the dilution of preferred creditor debt. The Bank currently faces a low risk of payment arrears because it holds a relatively small of the outstanding debt in each of the high debt countries, which receives preferred repayment treatment because of the Bank's special relations with the country. Debt obligations to preferred creditors (especially the Bank and the Fund) would rise in both absolute and relative terms under a debt reduction transaction. Preliminary estimates indicate that for the average country which participates in the scheme, the share of preferred creditor debt service in total public debt service may rise from 25% to 30% over the next three years. While this in itself is not an exceptionally large increase, there would be, in addition, a new stock of "secured" debt, whose service would be officially enhanced. Debt service on this new secured or "quasi preferred" debt may account for an additional 15-25% of total public debt service.

22. This expansion of preferred creditor debt may in turn reduce the flexibility in the country's debt structure and could pose risks to the Bank unless there is a reasonable assurance that external financing will be available on suitable terms and in adequate volume to meet the country's minimum requirements. The inherent uncertainty of macroeconomic forecasts underlines the importance of maintaining flexibility in the structure of debt. If too large a proportion of a country's debt service is preferred or partially secured, an adverse shock (external or internal) is more likely to affect the country's ability to service its preferred creditors. The risk is less if there is a "cushion" of more easily restructurable debt that can absorb the consequences of unforeseen debt servicing problems. This suggests that it will generally be preferable to achieve debt service reduction through more comprehensive transactions which encourage larger discounts and provide secured status to a smaller portion of the total debt, than those which result in smaller discounts with larger volumes of old debt participating and receiving "quasi preferred status". These concerns also suggest that the provision of IBRD enhancement funds should be limited to those cases where the overall ability of the country to service its debt and to sustain robust economic growth are materially improved.

IV. Modalities of Bank Intervention

23. In providing support for debt or debt service reduction operations, there are two issues of immediate concern: whether or not the so-called "set aside" funds and the "additional" funds should be separated, with the former to be directed solely to support debt reduction operations and the latter to be used for interest support, as proposed by Secretary Brady; and whether the Bank should retain flexibility concerning the modalities of its support for debt and debt service operations (i.e. employ either direct loans or guarantees as circumstances warrant), or should limit itself _al initio_ to providing support exclusively through loans.

24. In the Secretary's presentation, the suggestion of "setting aside" 25% of the Bank's adjustment lending to debt reduction (and a similar amount for the IMF) was offered as a general guideline for the order of magnitude of resources that would be both appropriate and consistent with on-going operations. Because of the variety of approaches to reform in different countries and differing needs for debt reduction, this cannot, nor was it intended to be, a rigidly applied formula to be applied to all countries for debt reduction support. While clearly the amount of lending for debt reduction would have to fall within the overall country program of adjustment lending, of which it would be a component, it would be prudent to allow scope for management and staff to determine the appropriate distribution of adjustment lending within a country program as discussed in the previous section. Given the overall demands for financing of imports, it is highly unlikely that a preponderence adjustment lending resources would be set aside for debt and debt service reduction operations in any country. Directors may wish to discuss guidelines for set asides in country programs.

25. As stated above, the Brady initiative envisages that the "set asides" should be used for debt reduction (buybacks or collateralization of below par exchanges). There are important political reasons for promoting debt reduction. In many cases where the overhang is large, a permanent reduction in the level of debt would be a critical element in restoring growth and eventual access to credit markets. However, there may also be cases where too large a program of debt reduction would drive up the market price too rapidly and thereby limit the benefits of this approach. Debt reduction may also provide less short term cash flow relief than interest support. [7] In some cases, a buyback (which is really a prepayment of debt at a discount) may not be the most appropriate strategy in a debt burdened country, which may need to defer its payments as much as possible. For these reasons, it seems preferable not to make a tight association between "set asides" and debt reduction actions. Directors may wish to support more discretion for the Bank to develop the mix of debt reduction and debt service reduction that best meets the country's needs on a case-by-case basis. Debt reduction would be supported by direct loans from the Bank to the debtor country to replenish reserves used for a buyback or for the country to purchase collateral for an exchange, provided the country can obtain, where necessary, waivers of sharing and prepayment clauses in its lending agreements.

26. World Bank support for interest payment reduction may be provided either by way of direct loans or through guarantees. The primary objective of Bank support for interest payments is to catalyze, and not substitute for, financing concessions by the commercial banks. For this reason, Bank support should be provided only in the context of appropriate relief arrangements from the banks. To play a genuinely catalytic role, interest support should encourage more favorable debt service reduction terms than merely the market value of the funds engaged in the operation. This additional benefit, or "halo effect", comes from the added "comfort" provided by the Bank's support of the reduced interest payments, and is a function of the type of support given. There is reason to be concerned that extension of the halo would involve some additional risk to the Bank through entanglement of the Bank in the relations between the debtor and its commercial creditors, complicating our country relations, or dilution of the Bank's prefered creditor status. The extent of this concern depends on several factors related to the instruments used.

27. In evaluating possible modalities of Bank interest payment support, the resulting choice ultimately may be said to turn on a judgment about the degree of entanglement that the Bank is prepared to risk in relation to the halo effect it may in return obtain.

7/ The companion paper on the economic aspects of debt reduction techniques addresses the analytic issues of debt reduction compared to service reductions.

28. Possible modalities of support on interest. There are three basic instruments for providing debt service reduction support:[8]

(i) loans specifically linked to escrow arrangements that would be used to pay banks in the event of non-performance by a country.

(ii) revolving lines of credit linked specifically to debt reduction transactions that would be available for service payments in the event of non-performance, and

(iii) guarantees on interest payments (one or two years rolling).

29. Loans into escrow accounts: Because funds in an escrow account will be specifically earmarked to cover interest payments in the event of non performance by the country, some more favorable terms might be expected from commercial banks than from a direct buyback. The degree of this halo will depend, however, on the extent to which the Bank is prepared to create linkages (e.g., through voluntary cross-default clauses) between drawdowns on the escrow account and its own lending program. If there were no restrictions on the ability of borrowers to draw down funds in the escrow account (other than that they be to meet interest payments), commercial banks are likely to value such comfort as being worth little more than the funding so provided. The greater the links with the Bank's lending program, on the other hand, the greater the entanglement and the greater the halo effect such an instrument would have. Waivers of negative pledge clauses from both the World Bank and the commercial bank loan agreements would probably be required for escrow accounts.

30. Lines of credit This is similar to lending for an escrow account, except that the funds would only be disbursed if the country were unable to make interest payments under the terms of the line of credit. Since the Bank would have already committed the line, it would not be seen to be lending into a default situation, as might be the case under a guarantee. The repayment terms of the line may be shorter than a normal loan, thus discouraging its use. However, drawdowns on such a line would not necessarily be dependent on an actual payment default occurring. Because of the potential for easy access, an important source of leverage over the borrower to continue its own payments may be lost. There is the possibility that the debtor and the banks may view it as only worth the value of the funds in the line, and there would be little halo effect unless other linkages were created. Negative pledge waivers are likely to be required.

31. Guarantees on Interest Payments: This instrument may have the greatest potential for providing a halo effect. The country's triggering

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8/ A wide range of variations on these generic types and combination of them can be conceived and some are likely to appear in specific deals. However, the key issues are raised with these three options.

the guarantee would probably appear more serious to the country than simply allowing an escrow account to disburse or drawing a line of credit. More favorable terms could then be obtained from the commercial banks. And guarantees can be structured more flexibly to cover temporary periods of interest reduction and other variations that are more difficult with direct loans. Countries could be further discouraged from drawing the guarantee if the Bank includes the typical clause whereby the Bank can insist on immediate repayment if the guarantee is called. This, however, may complicate other negotiations with the country, as failure to pay the Bank on the claim arising of the guarantee payment could be treated like any default to the Bank, i.e. as grounds for suspending loan disbursements, etc. The Bank would want to structure the guarantee to avoid being viewed as a bill collector for the banks.[9] Guarantees have the merit of avoiding the need to obtain negative pledge waivers.

32. Ultimately, it is important to consider the context in which support is to be given. The degree of Bank support must be calibrated to the degree of influence it can realistically expect to bring to bear to the process of resolving the external debt burdens of countries on a sustainable basis. Where there is the prospect of setting in place a framework which provides for a clear and sustainable resolution of a country's debt servicing difficulties, the potential costs of entanglement may be outweighed by the halo effect of a guarantee. Moreover, there may be transactions that the borrower is likely to treat preferentially, for example, where the debt instrument carries a very low coupon. The reduced risk of default would in turn reduce the risks associated with entanglement. Guarantees should not be ruled out in such circumstances.

33. However, for these countries where debt service reduction alone is not expected to offer a comprehensive solution to the country's debt burden, or where it is expected that the debt workout process will remain a prolonged and perhaps uncertain affair, less entangling forms of support may be preferable. The ability of the Bank in some circumstances to preserve flexibility in the future by avoiding excessive entanglements today will be important. The arms-length relationship established by loan arrangements would likely to be more appropriate in such cases.

34. Country circumstances, the extent of leverage and entanglement judged acceptable, and the availability of other resources from the IMF or third parties will all affect the type and extent of Bank involvement in debt and debt service operations. It is likely that lending operations will be the normal vehicle for these operations. However, in view of its possible merits, it would be desirable that the use of guarantees also be permitted in appropriate circumstances. Directors' views on the latitude

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9/ Under the Articles, the Bank has the right to terminate a guarantee in the event a default occurs. This may complicate writing a guarantee for more than one interest payment. However there appear to be ways around this problem. See Mr. Shihata's opinion on this subject, attached.

for choice of instruments to be used on a case by case basis would be welcome.

V. <u>Financing Assurances</u>

35. A major innovation of the Brady proposal is to give the international financial institutions greater flexibility to disburse in support of viable country adjustments programs where all the sources of financing have not been confirmed.[10] This issue is of greater immediate concern to the IMF because of the nature of its operations and its response to arrears. The IMF is currently developing its own guidelines in this area, which will be of great interest.

36. Since the Bank and the IMF will agree on individual country programs and medium term financing plans and since the Bank would not in any case disburse for debt or debt service reduction operations before the country and the commercial banks had reached an agreement, there does not appear to be a need for the Bank to develop separate guidelines for financing assurances in debt or debt service reduction operations, nor to depart from its present practices for other adjustment and project lending. By its articles and mandate, the Bank has a stronger interest in the longer term development and structural transformation of its members. This orientation would continue to be reflected in our judgments about the adequacy of medium term financing plans and in our own lending decisions.

37. The whole question of lending into situations where arrears are growing outside a formal agreement with the creditors accumulating arrears is nevertheless worrisome, as it may appear to give official sanction to the country's running arrears. In certain cases in the past, the Bank and the Fund have agreed to lend in cases of substantial and growing arrears, and it is now more likely this will occur in the future. Nevertheless, the dangers of moral hazard are there, and great caution should be exercised in this new environment. Management would assure close coordination with the IMF in this area in particular.

38. <u>Tranching and Disbursement Linkages with Commercial Banks</u>: As indicated above, the medium-term framework and financing plan for an adjustment program would outline the broad parameters of the financing package (debt reduction, interest reduction, new money) that would have to be negotiated between the country and the banks. While individual banks would have flexibility in deciding which elements to take up, the aggregate sum of the individual bank decisions would have to be broadly consistent with the financing package for the viability of the medium-term scenario. The Bank and the Fund disbursement procedures might have to be modified or

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10/ This is in contrast to the "critical mass" concept that has governed IMF operations in debt restructuring countries heretofore and that held that a critical mass of the financing had to be in place prior to the IMF approving its operation.

phased with commercial bank actions in a manner which would help to bring about the aggregate outcome posited in the financing plan.

39. If it appears that a much better deal can be struck if a relatively large debt or debt service reduction package is offered and if the Bank is confident of the country's commitment and ability to sustain its program, evidenced perhaps by strong prior actions, then it might be desirable to consider "front loading" the Bank's adjustment operation, or at least the debt or debt service reduction component of it. For example, most, or all of the "first" tranche could be allocated to debt or debt service reduction rather than an equal portion in each tranche.[11] Flexibility will be important, and the structure of each operation would have to be designed to assure both that the maximum amount of debt or debt service reduction is obtained and that the integrity and monitorability of the adjustment program is maintained.

40. In general, the tranche release conditions for the adjustment operation with debt or debt service reduction components should be designed to ensure that the medium-term adjustment program is on track and that the financing plan of the medium-term framework underlying the agreed adjustment program remains viable. It would probably not be wise, however, to make tranche releases conditional on the country reaching an agreement with its commercial banks so long as it is making good faith efforts to negotiate. Directors' views on this issue would be welcome.

41. Bank-Fund Relations: Close collaboration between the Bank and the Fund at all stages will be necessary. Full agreement on the medium-term macroeconomic framework, including the financing plan, and the broad dimensions of the financing package to be negotiated between the country and its financial creditors would be a prerequisite for debt or debt service reduction operations. Furthermore, it would normally be the case that both institutions have operations in support of the country's adjustment program. There would have to be coordination in the monitoring of the implementation of the program and of the judgement on the progress of the negotiations between the commercial creditors and the country. Differences in judgements on these matters would need to be resolved quickly along the lines set forth in the recent memorandum of understanding between the two institutions

42. Coordination of tranche release could be difficult because of the different approaches to tranching of the two institutions. In the Fund, the timing of tranche releases are normally at predetermined (quarterly, semi-annual) intervals against performance criteria agreed in advance. In the case of the Bank, the timing of tranche release is more uncertain, depending on the implementation of a preagreed set of actions. It is entirely possible that the release of a tranche of a Bank adjustment

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11/ If there were a delay in negotiations, this could conceivably result in the "second" tranche being disbursed first if its other conditions were met.

operation would occur at a time other than the regular program review undertaken by the Fund. Coordination of judgements on (a) the implementation of the program and (b) the progress of negotiations with commercial creditors may require extensive consultation and adequate scope for achieving full consultation and agreement between the institutions will have to be assured. The question of what happens if one institution believes its tranche should be released when the judgement of the other is against release will require further discussion prior to undertaking operations. This is another facit of the always delicate question of cross conditionality, and Directors' views are sought.

IBRD Role in Catalyzing New Money

43. In the past the Bank has taken a very active role in helping countries mobilize new money packages from its commercial creditors. This catalytic role has relied on a variety of factors, including the Bank's own lending program, its policy of conditionality, disbursement linkages and more formal cofinancing arrangements. With the shift in emphasis to accelerated debt and debt service reduction support by World Bank funds, commercial banks will now need to reach new agreements among themselves as to the appropriate balance between new money and debt reduction. The Bank's catalytic role would thus be very complex if it were expected to simultaneously promote new money and debt reduction. As a result, it may be necessary and/or appropriate for the Bank to adopt a much less active role in the new money process, leaving it largely to the countries and to its commercial bank creditors to determine the menu options without official intervention. However, debt and debt service reduction options would have to meet the criteria discussed above to qualify for financial support from the Bank.

VI. Summary of Issues for Consideration by Directors:

44. The preceeding discussion offered some backgound on a number of issues where guidance from Directors is solicited. These issues are summarized below to guide the discussion:

- Is it appropriate to set the eligibility criteria in terms of the country's adjustment program and potential benefit from a debt or debt service reduction program?

- Are the proposed amounts allocated from the set asides and possible increments to Bank lending appropriate?

- Are the risks associated with lending for debt or debt service reduction and with allocating incremental amounts to this activity over a three year period acceptable?

- How much flexibility should be retained in determining the mix between debt and debt service reduction in individual country programs?

- Should the Bank retain flexibility in the choice of options for debt service reduction between direct lending instruments and guarantee instruments?

- Is the approach to financing assurances in the Bank's decisions on lending satisfactory?

- While maintaining close coordination with the Fund, should there be any modification in our criteria for tranche release conditions in operations involving debt and debt service reduction?

April 14, 1989

TO: Messrs. Fischer, DECVP; Wood, FPRVP; Shihata, LEGVP; Dubey, EAS

RE: Draft Papers on Debt

Attached are copies of the IMF Board Papers that we were given late last night. They are not yet approved by Management and have been given to us by Fund Management on a need-to-know basis. I would suggest that written comments be channelled through me; however, if you prefer, I would be happy to arrange a meeting with the Fund. Obviously, they would like to have comments as early as next week.

David Bock

cc: Messrs. Qureshi, OPNSV
Stern, FINSV
Ms. Haug, EXC

Office Memorandum

TO: Heads of Departments
AFR, ASD, EUR, EXR, FAD,
LEG, MED, SEC, TRE, WHD

April 13, 1989

FROM: L.A. Whittome

SUBJECT: Draft Papers on Debt

I attach drafts of three papers which have been hastily written and have to be circulated to Executive Directors before the end of next week. The first has been drafted jointly by RES and ourselves, while the others draw on discussions with several other departments. We would appreciate your comments by c.o.b. Monday, April 17.

It is intended that these papers should form the basis for one or two informal Board discussions presently timed for early May. A little later the Mexican paper will force some decisions. We presume that we are toward the beginning of a long process.

Attachments

Record Removal Notice

The World Bank Group Archives & Records Management

File Title	Barcode No.
Financial Files - Debt - Correspondence - Volume 1	1466051

Document Date	Document Type
Apr 13, 1989	Report

Correspondents / Participants

Subject / Title
International Monetary Fund
Fund Support for Debt Reduction
Operations - Preliminary Considerations

Exception No(s).

☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐ 6 ☑ 7 ☐ 8 ☐ 9 ☐ 10 A-C ☐ 10 D ☐ Prerogative to Restrict

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File Title	Barcode No.
Financial Files - Debt - Correspondence - Volume 1	1466051

Document Date	Document Type
Apr 13, 1989	Report

Correspondents / Participants

Subject / Title
International Monetary Fund
The Debt Situation : Country Circumstances and Financing Approaches

Exception No(s).

☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐ 6 ☑ 7 ☐ 8 ☐ 9 ☐ 10 A-C ☐ 10 D ☐ Prerogative to Restrict

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Chandra Kumar	Aug 5, 2014

Record Removal Notice

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File Title	Barcode No.
Financial Files - Debt - Correspondence - Volume 1	1466051

Document Date	Document Type
Apr 12, 1989	Report

Correspondents / Participants

Subject / Title
International Monetary Fund
The Fund's Policy on Financing Assurances

Exception No(s).

☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐ 6 ☑ 7 ☐ 8 ☐ 9 ☐ 10 A-C ☐ 10 D ☐ Prerogative to Restrict

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Withdrawn by	Date
Chandra Kumar	Aug 5, 2014

OPS

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: April 12, 1989

TO: Mr. Moeen A. Qureshi

FROM: David R. Bock

EXTENSION: 72942

SUBJECT: World Bank Role in Providing Interest Support

1. This memorandum is in response to your request for a short note on the role that the Bank should play in providing interest support to debt reduction transactions in the context of the Brady Proposals.

2. First of all, it is important that the Bank should plan to provide support for interest payments along the lines suggested by the Treasury. However, the attempt by the Treasury to compartmentalize Bank resources for debt reduction purposes, i.e. to restrict the 25% set aside to debt buybacks and principal defeasance is not appropriate. The Bank's resources for debt reduction should be applied flexibly on a case-by-case basis and that we should resist compartmentalizing such resources at this stage. Whatever we say to countries, banks and others should be couched in terms of making available a portion of our resources for a variety of purposes including buybacks, defeasance and interest support.

3. Second, we have no fixed views on the amount of Bank resources that should be committed to interest support. (We believe Finance is not troubled by the proposal of an additional $2 billion per year over the next three years.) How this will be allocated by country is the crucial issue. At this point, it is probably safe to assume that the allocation approach should be such that if only a few countries qualify for the program, then much less than $6 billion would be committed for this purpose.

4. Third, there are four basic instruments for providing interest support:

(i) direct loans to the borrower to replenish reserves or provide free foreign exchange;

(ii) loans specifically linked to escrow account arrangements;

(iii) guarantees on interest payments; and

(iv) revolving lines of credit linked specifically to debt reduction transactions.

5. There are a variety of implications for the Bank, the borrower and commercial banks emanating from each of these instruments--see the Attachment for a matrix providing a summary comparison of certain important issues. Fundamentally, however, we see the choice of instruments turning on a judgment call: is one more concerned about "entanglement" with the claims of commercial banks? Or is "leverage" a more important concern?

6. Direct loans to replenish reserves. This clearly represents the weakest form of Bank support and will be viewed as such by commercial banks. It is unlikely to generate any greater response by commercial banks than is currently derived from current Bank lending activities. In other words, while there is no danger of entanglement arising (other than the public sector holding an increased share of country exposure), there is no leverage to be obtained.

7. Loans into escrow accounts. Because funds in an escrow account will be specifically ear-marked to cover interest payments, some leverage over commercial banks might be expected (i.e., the banks might agree to greater debt reduction than they might otherwise consider). The degree of leverage will depend, however, on the extent to which the Bank is prepared to create links (e.g., through voluntary cross-default clauses) between drawdowns on the escrow account and its own lending program. If there are no restrictions on the ability of the borrowers to draw down funds in the escrow account (other than that such must be to meet interest payments), banks are likely to evaluate such comfort as being worth only as much as the funding so provided. The greater the links with the Bank's lending program, on the other hand--the greater the "entanglement"--the greater the leveraging effect such an instrument will have.

8. Guarantees. The entanglement issue associated with guarantees is now well-understood. "Entanglement" refers to two matters: (a) the Bank's obtaining a claim on a country at a time of, and because of, a default by such country; and (b) the consequent risk that the Bank will (i) seek to prevent such a claim from arising by in effect acting as a policeman for the banks; and (ii) find that problems in collecting on such claim will adversely affect other Bank claims on such country. We believe it is easy to overstate the "entanglement" risk: everything depends on the nature of the contract, the instrument to which it applies and--especially--the understanding reached at the outset as to what we will do vis a vis the borrower if the guarantee is called. Moreover, guarantees are far simpler administratively for both the Bank and the borrower, and are likely to be cheaper than escrow account.

9. The main advantage of the guarantee instrument is that it strengthens the Bank's negotiating leverage vis-a-vis the borrower and vis-a-vis the commercial creditors on the terms of the transaction. By contrast, there is a risk that no one will pay much attention to the Bank if it is simply making an arm's length loan to the country. At

best, we could influence the transaction only through the general guidelines for use of Bank resources and the requirement that we approve the terms of debt reduction transactions for which Bank resources would be used. This is not a negligible amount of leverage, but will not involve us as deeply in structuring the transaction as would a direct guarantee. (The direct involvement would be likely to be intense at first, diminishing as the approach becomes fairly standardized after 2 or 3 transactions.)

10. Thus, the issue concerning guarantees is whether we wish to use them as a tool to proactively shape the debt reduction process (i.e., obtain significant leverage), but accept the risks of entanglement; or whether we wish to preserve flexibility for the Bank in the future by avoiding entanglement today.

11. Lines of Credit. This is an attractive alternative to guarantees if it is thought that concerns (particularly by the Bank's bondholders) about lending into a default--as guarantees may be perceived--are significant and realistic. This is because drawdowns on such a line need not be dependent on a payment default occuring. Again, line of credit can be designed in a variety of ways to achieve some of the features of both loans and guarantees.

12. The crucial issue on the choice between guarantees and other less involved instruments is the extent to which the Bank wants to take a leadership role in shaping the debt reduction process and specific debt reduction transactions. Clearly, direct loans and escrow arrangements are less obviously risky for the Bank than guarantees and raise fewer policy issues vis-a-vis the shareholders. Our view is that it would be a mistake to close off totally the guarantee option at this stage. Rather, we should simply indicate to the various parties that we are still considering the issue, that we are acutely aware of the risk shifting and entanglement questions, and that we are likely to want to restrict guarantees to situations where there is a clear resolution of a country's debt servicing difficulties or where the transaction itself is implicitly preferred due to structural characteristics such as low interest rates associated with par swaps.

Attachment

cc: Messrs. Fischer, Shihata, Wood, Ms. Haug
Shilling, Toft, Flannery

NEAR-TERM BANK SUPPORT FOR DEBT REDUCTION

Comparison of Rolling Guarantee, Escrow Account and Line of Credit

For the Bank:

Issues	Rolling Guarantee of Interest	Escrow Account	Line of Credit
Capital Requirments	Capital would be set aside up-front for the amount of the guarantee; no adjustments in lending required thereafter.	Equivalent capital usage; funds are disbursed (as loan) to finance escrow account. Further reductions in commitment authority not needed.	Same capital requirements as the others; capital would be set aside at the time of commitment of the line of credit.
2. Country Exposure	Direct exposure limited to amount of guarantee; remains constant until exit bonds repaid or guarantee released.	Equivalent direct exposure; remains constant from time of disbursement until IBRD loan (used to finance escrow) is repaid.	Exposure limited to commitment under line of credit as in guarantee.; remains constant until line of credit expires or bonds repaid.
3. Flexibility for limiting Bank support on exit bonds.	Tenor of guarantee can be specified up-front. Also payment of guarantee fee by lenders represents incentive to release guarantee.	Flexibility limited, especially if the escrow is established beyond purview of the Bank.[a] Also no incentive for credit support to be released early.	Availability of line of credit can specified up-front. But no incentive for early release since commitment fee is paid by debtor.
4. Borrower relationship	Could strain relations if efforts to avoid a triggering of the guarantee include attempts to secure additional Bank resources.	If drawdown from escrow is automatic, less potential for adverse influence on Bank's own program. But potential for strain exists if drawdowns are avoided through efforts to secure more Bank finance.	Same as escrow, if drawdown under credit line are straightforward. However, if drawdowns are viewed as a last resort to service interest, could threaten relation with borrower.
5. Currency mismatches	Guarantee can be committed in currency of exposure under current policy. Thus no potential for mismatch between borrower's liability under the exit bond and the credit support being provided.[b]	Would require single currency IBRD loans to prevent a mismatch between the borrower's liability to the Bank and interest payments being earned on the escrow. Especially in the context of a debt reduction exercise, this could be sensitive.	Under current policy, Bank loans are committed in US dollars and for vast majority of operations this would imply no mismatch.[b]
6. Flexibility for indemnification of Bank.	The Bank's eventual indemnification by the borrower, if the guarantee is called, could be structured in a flexible manner.	Not an issue. But IBRD loan financing the escrow account has a fixed repayment schedule.	Same as escrow account. Not an issue, but line of credit would have a fixed repayment schedule.
7. Subrogation Rights.	Bank would insist on subrogation that is independent of status of other claims on the debtor.	Not applicable. There is a clear demarcation of IBRD claims (as preferred) from other claims.	Same as escrow account. Bank claims arising from drawdowns would be clearly demarcated.

a. Prepayment of IBRD loan would not alter credit support of escrow on exit bond.
b. If the guarantee is called, or line of credit drawn down, the borrower's liability could thereafter move differently from the amount initially paid out by the Bank.

For the Borrower:

Issues	Rolling Guarantee of Interest	Escrow Account	Line of Credit
1. Obligation to the Bank	Contingent obligation, with room for flexibility in the event it is triggered.	Fixed obligation with defined repayment schedule.	Obligation is contingent on drawdown, but repayment schedule is fixed.
2. Ease of access to credit support	Specter of triggering guarantee may result in somewhat higher pressure to avoid a default.	Escrow account may be viewed as a convenient liquidity cushion, with few controls on its use.	Similar to escrow, unless specific conditions restricting withdrawal are established.
3. Cost of credit support	No direct cost, since guarantee fee is paid by the lenders. However, the fee may influence the exchange ratio between old debt and exit bonds.	Negative cost of carry on the escrow account, of about 50 basis points, would be borne by the borrower.	Commitment fee on line of credit would be paid by borrower.
4. Negative pledge considerations	Waiver not required.	Debtor would require waivers to establish escrow account.	Waiver not required.

For the Commercial Banks:

Issues	Rolling Guarantee of Interest	Escrow Account	Line of Credit
1. Involvement of IBRD	IBRD involvement in the exit bond continues throughout. This is more attractive to commercial banks.	Lack of Bank involvement detracts from its attractiveness (which could be reflected in exchange ratio for old debt).	Depending on conditions governing drawdown, IBRD involvement would be in-between the guarantee and escrow account.
2. Financial cost of credit support.	Reflects a higher cost since lenders are charged a guarantee fee. But may be able to pass on to borrower by adjusting exchange ratio on old debt.	No direct cost to lenders; borrower is responsible for costs of maintaining escrow account.	No direct cost to lender, since commitment fee is paid by the borrower.

NPaul/SRajasingham
DFS

April 12, 1989

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

March 23, 1989

TO: Mr. Barber Conable, EXC

FROM: D. Bock, DFS, S. Fischer, VPDEC, I. F. Shihata, LEGVP, D. Joseph Wood, FPRVP

SUBJ: **The Brady Plan: Issues for the World Bank**

There are six major issues surrounding the Bank's participation in the Brady Plan:

1. Adequacy of resources relative to the size of the problem. The amounts apparently available for debt reduction appear, from preliminary calculations, inadequate to address the total funding problems of the Brady countries. Some countries will need new commercial bank money. It will be essential in each case to work out a full funding plan that takes into account the amount of debt relief and new money. The forms of debt reduction sanctioned by the Brady Plan must not preclude commercial bank participation in providing new money in whatever form in sufficient amounts.

2. Country eligibility. (a) It is necesssary to develop objective criteria by which countries become eligible for this program. We have to deal with difficult questions about how to treat countries that have been promptly and regularly servicing their debt, despite heavy debt burdens, but whose debt is not selling at discount. (b) Only those countries which have a comprehensive medium-term adjustment program and a viable financing plan should be eligible.

3. Adjustment programs and financing plans. The Bank and Fund will have to agree on a debtor country's adjustment program and on the country's financing plan. Release of tranches would be linked to demonstrated performance of conditionality laid down in the program. Additionally, there should be a precondition for bank support that it will only finance debt relief if a country has negotiated a minimum discount on the existing debt with its commercial bank creditors.

4. Form of debt reduction. The advantages of alternative forms of debt reduction for the debtors and for the Bank have to be considered: (a) The initial proposals for debt reduction are reduced interest rate, debt exchanges, debt buybacks, debt-equity swaps etc. (b) If the Bank provides credit enhancement for interest rate reduction we have to examine whether in each case it should take the form of guarantees, standby line of credit, straight loans or some other alternate or hybrid form of guarantee or lending. (c) Alternative forms of debt reduction, including interest rate reduction for specified period for say five years, may need to be explored.

5. <u>Tax and regulatory measures</u>. Since preliminary analysis shows a significant funding problem despite Brady debt reduction measures, industrial country tax and regulatory changes will have to be an essential component of the Plan. These changes should be in place before or concurrently with Bank and Fund assisted debt reduction programs. The changes should aim at providing incentives for the banks to participate in debt reduction and penalizing free riders

6. <u>Availability of additional official financial resources.</u> Since the resources of the Fund and Bank may not be adequate to address the needs of the Brady countries, (in part because funds used in buybacks are not available for investment), it will be important to seek alternate sources of official finance.

These issues are examined in more detail in the attached note.

DECVP

March 23, 1989

The Brady Plan: Issues for the World Bank

I. Adequacy of resources relative to the size of the problem How much debt relief is possible through this initiative? Does the scheme, as now envisioned, provide the amount of relief that is necessary for adequately funded adjustment programs. The actual relief, i.e., the reduction in net resource transfers by debtor countries to their creditors will depend on a number of factors: (a) the size of the discount on the existing loans; (b) the form of debt reduction, e.g., buy back, interest rate reduction, etc.; (c) the differential in interest rate between the commercial bank and the WB/IMF loans used for debt reduction; (d) the additionality of new money and net lending from commercial banks and/or officials sources and (e) the strength of the tax and regulatory measures. We have reached three tentative conclusions:

> Preliminary analysis indicates that the amounts apparently available for debt reduction will not be adequate to meet the total funding problems of the Brady countries.
>
> Our preliminary calculations show that if the discount is reasonable, the exchange offers with reduced interest rates may be a more attractive option than the debt buy backs, at least in large countries whose debt is owed mainly to commercial banks.

New money, in the least debt distressed countries, and some method of further "leveraging" IFI and other official funds are likely to be required if the Brady scheme is to succeed. That leverage could take the form of official tolerance of arrears to free riders and favorable tax and regulatory treatment of debt exchanges.

It may be that new money will be part of financing perhaps for the large countries while small countries are financed mainly through debt reduction.

II. Country Eligibility. The Bank and Fund must develop objective criteria for the identification of countries eligible for the program. The 39 countries identified by the Treasury as eligible for assistance (on the basis of having rescheduled commercial bank debt since 1983) include ten small African countries that owe less than 10 percent of their debt to commercial banks. Major commercial bank debtors such as Colombia and Hungary are excluded. The Bank and Fund Boards must deal with the problem of the eligibility of countries that have been prompt in servicing their debts, despite liquidity problems, but whose debt is not selling at a discount. To be eligible, a country must have in place a comprehensive adjustment program and have worked out a viable financing plan.

III. Adjustment programs and Financing Plans. The Bank must address a set of issues relating to adjustment and financing plans:

(a) Who "approves" the financing plan of an eligible debtor country? The Bank and Fund should be in agreement on the plan, if the country has to establish access for financial assistance. In that event, the two institutions have to develop joint criteria as to the content of an acceptable Brady Plan adjustment program.

(b) What are the criteria for the provision of new money versus debt reduction in a financing plan? The Bank, Fund, and regulatory authorities must consider their policy stance concerning arrears to commercial bank creditors that resist negotiating or signing agreements which fit in an "approved" financing plan.

(c) The Bank should insist on a threshold discount in debt reduction agreements as a precondition for its support. Otherwise the Bank faces the danger of creditor debtor agreements which unduly benefit commercial banks at the expense of the debtor country and the World Bank.

(d) Bank and Fund support must be tranched to achieve the maximum policy performance leverage. The Bank and Fund will be taking on a high level of risk. The two institutions must be assured that the funds to be made available will be used efficiently. Release of tranches must be made conditional on demonstrated performance under negotiated adjustment programs.

IV. Forms of Debt Reduction. Again the Bank faces a set of issues:

(a) Debt relief can take several forms: new money; cash buy-backs; old debt for new debt exchanges in which the new debt carries a lower face value (Mexico-Morgan) or a lower interest rate (Brazil exit bonds); and debt-equity swaps. Debt exchanges can be "credit enhanced" through guarantees, collateral, or some form of senior creditor status. In the extreme, a fully guaranteed or collateralized exchange is equivalent to a buyback.

(b) Bank credit enhancement techniques must be examined. Alternative forms of credit enhancement include guarantees, lending for collateral to be placed in escrow accounts, stand-by lines of credit or combinations of these techniques. At an abstract level, all forms of credit enhancement are equivalent. However, Bank bondholders, commercial banks and their regulators, and the debtor countries may value these instruments differently. The Bank should investigate the advantages and disadvantages of alternative credit enhancement techniques.

(c) Our preliminary analysis indicates that, for some debtor countries, an assured stream of new money may be adequate without need for any debt reduction. Since it is likely that most of the countries would, on political grounds, ask for debt relief the real issue is the proportion in which the financing gap is filled through debt reduction and new money. Should the Bank support interest capitalization in these countries and push for favorable regulatory treatment of capitalized interest? Alternatively, should new money be credit enhanced by the Bank and Fund? Should the countries receiving new money be allowed to buy back debt if they are in compliance with their adjustment program and are current on interest?

(d) Many debtor countries require debt reduction. Forms of debt exchange that provide immediate interest rate reductions appear to provide the biggest cash flow advantage. Interest rate reduction for a specified period of time, five years for example, appears to be an attractive option to consider.

(e) The type of <u>conditionality</u> connected with Bank financial support will be affected by the form of debt relief. New money can be tranched. Buybacks would require prior adjustment measures. Debt exchanges can be designed to provide relief conditional on policy performance. For example, interest can be reduced if adjustment measures are followed or capitalized if policy performance deteriorates.

(f) What will be the <u>sequencing</u> of debt relief? Should it be done in a series of operations or relatively quickly? If pure buybacks are the major tool, sequencing provides a greater degree of policy conditionality leverage. Immediate cash-flow needs argue for quick debt exchange agreements with commercial creditors, incorporating conditional interest rate reductions.

(g) <u>Pricing</u> of debt buybacks and exchanges is also an issue. Should the prevailing secondary market price be taken as a rough benchmark? Should the pricing be left to negotiations between creditors and the debtor country? There should be a minimum discount below which the Bank should not use its resources to support debt reduction. Prices will tend to rise as new resources are devoted to buybacks; commercial banks may tend to benefit disproportionately. A minimum discount would help to alleviate this problem.

V. <u>Tax and regulatory measures</u>.

(a) Preliminary analysis indicates that the debt reduction measures envisioned in the Brady Plan will not be adequate to meet the financing needs of the Brady countries. Tax and regulatory measures will be required to ensure that commercial banks do their share. Free riders must be penalized for nonparticipation in new money or debt reduction exercises. For example, free riders could be forced to create non-tax deductible reserves, separate from capital, while participating banks are allowed to count interest paid as a part of income. Regulatory and tax authorities should consider favorable treatment of payment in local currency.

(b) The importance of these tax and regulatory measures means that they cannot be delayed; these changes should be negotiated quickly. These measures must be in place before or concurrent with the introduction of Bank and Fund assisted debt reduction plans.

VI. Availability of Official Financial Resources. Unless debt reduction is significant, it will not meet the financing needs of the eligible countries. As noted above, our preliminary analysis indicates that the level of support currently envisioned from the Bank and the Fund, while likely at the limit of prudency for the two institutions, would not be adequate to meet the financing needs of the Brady countries. How firm is the support of the Japanese for the Plan? Can they, and other surplus countries, contribute additional amounts?

ANNEX 1

CONFIDENTIAL

March 23, 1989

TO: Selected Brady Proposal Task Force Members,

You may be interested in the attached tables prepared by Don Hanna. These are among a series of projections we are preparing under alternative assumptions. Essentially, these represent an effort to take the rough aggregate numbers suggested by U.S. Treasury officials and explore what this might imply at the country level for IBRD exposure and unfilled financial gaps.

The assumptions are clearly arbitrary and there are obvious extensions to this analysis. Over the next few days, we will be focussing on (i) obtaining a better assessment of the financing requirements at the country level (see last two columns of tables 1-3), and (ii) working through the implications of this kind of analysis in more detail for 2 or 3 countries, and (iii) extending the analysis to allow for larger reductions in interest payments in early years followed by rising interest obligations over time.

Table 4 shows the sensitivity of some of the results to alternative exchange price assumptions.

Your thoughts and suggestions would be appreciated.

Andrew

Andrew Steer

Attachments

Distribution
Messrs. Wood, Fischer, Rao, Bock, Dubey, Grilli
Holsen, Shilling, Husain, Underwood, Claessens
Kilby, Rajasingham, Johannes, Paul, Morais

EXPLANATION OF TABLES 1-3 - The Mulford Numbers

The attached tables attempts to approximate the rough magnitudes suggested by U.S. Treasury officials over the last week. Four "pots" of money are assumed to be available as suggested by the UST. The use of these sources is assumed as follows:

IMF "set aside"	--	buybacks
IBRD "set aside"	--	principal defeasance for debt conversion
IMF and IBRD additional funds	--	interest coverage on debt conversion

1. Take 25% of High Case Adjustment Lending for the remainder of FY89 and for FY90-92. For the 20 countries in our sample, this amounted to $3.3 billion. This is less than the sum assumed by the UST. Since some countries (Costa Rica, Chile, Bolivia, Peru) have no adjustment lending scheduled, we have added funds for them, and also added to the Mexico program to make it consistent with the current plans. These adjustments raise the total for the IBRD "set aside" for the 20 countries to $3.7 billion. For some countries (at some exchange prices), the allocated amounts are more than sufficient to defease all commercial debt. Those countries are marked with an asterisk, and surplus funds are allocated to countries with a small volume of adjustment lending.

2. Pro-rate $5.5 billion of IBRD additional funds, so that each country's debt conversion receives the same interest coverage (in terms of months). The difference between $5.5 billion and the $6-7 billion assumed for the UST is accounted for by the additional 19 (mainly small) countries.

3. Pro-rate $5.5 billion IMF additional funds in the same manner.

4. Use $5.5 billion of IMF "set aside" to buy back debt, pro-rated across countries in the same manner as the interest coverage.

Interest Rates and Maturities. For simplicity, all interest rates are assumed to be 10%. Reduced interest payments are therefore calculated as 10% of the reduced debt level, and funds set aside for defeasance are assummed to accumulate at 10% p.a. The new bonds are assumed to be 30 years with bullet maturity at 10% interest. This implies that $5.7 is required to defease $100 of new bonds. A 9% interest rate assumption would required $7.5 and 8% would require $9.9.

The Exchange Price. For the buybacks, an exchange price 25% higher than the current secondary market price is assumed in each table, giving a weighted average price of 38 cents, in comparison with the current secondary market price of 29 cents. For the debt conversions, three assumptions are made:

Table 1 - assume an average conversion rate of 60 cents (i.e., $100 of old debt would be exchanged for $60 of new bonds). Conversion prices for individual countries are pro-rated

according to their current secondary market prices to give this weighted average. The 60 cents average assumes some value is attached to the quasi-preferred status of the new bonds.

Table 2 - here assume that commercial banks attach no value to the quasi-preferred status of the bonds. This lowers the value of the bonds and raises the conversion rate (the ratio of the secondary market price of debt to the cash value of the bond). The table gives a good idea of the minimum savings from exchange offers of this type.

Table 3 - here assume the commercial banks value the quasi-preferred status of the bonds sufficiently to lower the conversion rate to an average of 50 cents. This gives a reasonable upside for potential savings.

Exposure Calculations. Interest coverage by the Bank is assumed to take the form of lending into an escrow account. Debt service to the Bank should therefore include obligations stemming from these loans. It does not yet, due to time constraints, although it does include debt service on the principal defeasance loans.

Two calculations of preferred creditor (PC) debt are made. "Core PC" refers to the usual definition and includes the new IBRD and IMF loans. "Quasi PC" refers to the new bonds.

Financing Requirements. Overall requirements and (particularly) requirements from commercial sources are being refined in discussions with Regional staff this week. The numbers included are, in our judgment, probably about right in the aggregate, but may need substantial revision at the country level.

EXPLANATION OF TABLE 4

Taking the same type of arrangement as in tables 1-3, this tests the sensitivity of the results to changing assumptions on the transactions price. In each case, the transactions price of the buyback is assumed to be 15 cents lower than that for the conversion.

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Table 1: MULFORD LUMBERG /e

Country	Commercial MLT Debt end-1988 ($ million)	Secondary Market Price (cents)	IBRD Set Aside Adjustment Lending High Case: Remaining FY89	FY90-92	Update	Total	Adj /c	25% of Total	Additional IBRD Funds	IMF: Set Aside	IMF: Adtl. Funds
Argentina	45211	18	0	1287	0	1287	0	322	654	462	654
Bolivia	125	10	0	0	19	19	-[illegible]	5	4	7	4
Brazil	67875	28	0	2688	0	2688	0	672	1043	966	1043
Chile	11845	56	0	0	300	300	0	75	94	108	94
Colombia	4819	51	0	165	0	165	0	41	53	59	53
Costa Rica	1731	15	0	0	150	150	-5	38	75	54	75
Cote d'Ivoire	3937	17	0	642	0	642	-89	161	149	231	149
Ecuador	5374	13	0	118	48	166	0	42	112	60	112
Honduras	521	18	0	133	0	133	-25	33	16	48	16
Jamaica	575	43	0	100	0	100	-5	25	26	36	26
Mexico	65229	34	300	1821	1285	3406	0	851	1199	1223	1199
Morocco	4562	45	0	817	0	817	-43	204	211	294	211
Nigeria	11437	22	0	2236	0	2236	-307	559	444	803	444
Peru	8668	6	0	0	200	200	0	50	327	72	327
Philippines	12744	37	250	488	0	738	0	184	256	265	256
Poland	12656	33	0	267	0	267	0	67	97	96	97
Uruguay	2389	58	140	112	0	252	0	63	79	91	79
Venezuela	24817	28	0	450	846	1296	0	324	511	466	511
Yugoslavia	7172	44	150	150	150	450	0	113	149	162	149
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Total	291687	30	840	11474	2998	15312	-478	3828	5500	5500	5500
o.w. HICs	278510	29	840	11074	2998	14912	-452	3728	5387	5356	5387

Country	Buyback (IMF Set Aside): Exchange Rate	Debt Offered	% of Total	Debt Reduced	Interest Savings	Conversion: Exchange Rate debt/bonds	Volume of Debt Offered	% of Total	Int. Cvg. Years: IBRD	IMF	Interest Savings	GDP USD bn
Argentina	23	2054	4.5%	1592	159	45	12541	27.7%	0.9	0.9	690	65.6
Bolivia	13	55	43.5%	48	5	27	71	56.5%*	0.9	0.9	5	4.5
Brazil	34	2809	4.1%	1843	184	59	19984	29.4%	0.9	0.9	819	337.1
Chile	70	154	1.3%	46	5	73	1802	15.2%	0.9	0.9	49	20.2
Colombia	64	93	1.9%	34	3	71	1021	21.2%	0.9	0.9	30	42.3
Costa Rica	18	297	17.2%	243	24	40	1433	82.8%*	0.9	0.9	86	4.3
Cote d'Ivoire	21	1086	27.6%	855	86	44	2851	72.4%*	0.9	0.9	160	10.2
Ecuador	16	368	6.8%	308	31	34	2145	39.9%	0.9	0.9	142	6.6
Honduras	23	213	40.9%	165	17	45	308	59.1%*	0.9	0.9	17	4.5
Jamaica	53	68	11.7%	32	3	69	507	88.3%*	0.9	0.9	16	3.2
Mexico	42	2900	4.4%	1676	168	65	22980	35.2%	0.9	0.9	804	184.8
Morocco	56	522	11.4%	228	23	70	4041	88.6%*	0.9	0.9	121	19.1
Nigeria	28	2920	25.5%	2117	212	52	8517	74.5%*	0.9	0.9	409	29.0
Peru	7	1045	12.1%	973	97	14	6266	72.3%	0.9	0.9	539	9.9
Philippines	46	573	4.5%	308	31	66	4902	38.5%	0.9	0.9	167	41.2
Poland	41	236	1.9%	140	14	63	1857	14.7%	0.9	0.9	69	54.1
Uruguay	73	125	5.2%	34	3	73	1514	63.4%	0.9	0.9	41	12.3
Venezuela	35	1330	5.4%	865	86	58	9800	39.5%	0.9	0.9	412	60.6
Yugoslavia	55	292	4.1%	131	13	69	2860	39.9%	0.9	0.9	89	55.2
Total	38	17138	5.9%	11638	1164	61	105400	36.1%	0.9	0.9	4662	988.8
o.w. HICs	36	16690	6.0%	11333	1133	60	103235	37.1%	0.9	0.9	4129	930.1

Country	Interest/GDP 1990: w/o Scheme	with Scheme	Reduction	Preferred Creditor Debt w/o Scheme 1988: USD bn	% Total	1990: USD bn	% Total	with Scheme "Core" PC /a: USD bn	% Total	"Quasi" /a: USD bn	% Total	Total PC: USD bn	% Total
Argentina	5.2%	4.4%	0.8%	8.0	14.3%	9.8	16.8%	11.1	22.2%	12.5	22.0%	23.7	44.2%
Bolivia	4.7%	4.5%	0.2%	1.7	42.1%	2.1	42.3%	2.2	43.3%	0.1	1.4%	2.2	44.7%
Brazil	2.6%	2.4%	0.3%	13.9	15.4%	13.3	14.7%	15.4	19.1%	20.0	22.5%	35.3	41.6%
Chile	8.1%	7.9%	0.2%	3.6	22.2%	3.7	23.3%	3.9	25.3%	1.8	11.4%	5.7	36.7%
Colombia	2.5%	2.4%	0.1%	6.1	42.4%	6.5	42.8%	6.6	44.5%	1.0	6.7%	7.7	51.2%
Costa Rica	7.0%	4.7%	2.3%	1.1	30.1%	1.1	28.7%	1.3	44.7%	1.4	38.2%	2.7	82.9%
Cote d'Ivoire	7.7%	5.3%	2.3%	2.2	25.1%	2.6	26.1%	2.9	38.5%	2.9	31.0%	5.8	69.5%
Ecuador	9.0%	7.5%	1.5%	2.7	30.9%	3.5	43.0%	3.7	58.1%	2.1	27.5%	5.9	85.6%
Honduras	3.4%	2.8%	0.6%	1.4	56.8%	1.4	53.8%	1.4	63.2%	0.3	12.7%	1.7	75.8%
Jamaica	8.7%	8.2%	0.5%	1.6	47.2%	1.5	41.7%	1.6	45.6%	0.5	14.2%	2.1	59.8%
Mexico	4.4%	3.9%	0.5%	16.2	19.5%	17.2	18.9%	19.6	24.0%	23.0	25.6%	42.6	49.7%
Morocco	6.0%	5.3%	0.6%	5.0	26.5%	5.6	27.8%	6.0	32.2%	4.0	20.3%	10.1	52.5%
Nigeria	8.3%	6.0%	2.3%	3.3	11.2%	4.8	14.6%	5.7	21.4%	8.5	27.9%	14.2	49.2%
Peru	6.7%	4.2%	2.6%	0.0	ERR	2.4	15.4%	3.1	32.9%	6.3	42.6%	9.3	75.5%
Philippines	5.4%	5.0%	0.4%	6.4	26.4%	7.1	27.0%	7.6	31.3%	4.9	18.8%	12.5	50.1%
Poland	7.0%	6.8%	0.2%	0.0	0.0%	0.6	1.6%	0.8	2.2%	1.9	5.1%	2.7	7.3%
Uruguay	2.8%	2.5%	0.3%	0.9	29.8%	0.8	24.1%	1.0	32.9%	1.5	44.3%	2.5	77.2%
Venezuela	5.8%	5.0%	0.8%	0.3	1.1%	4.6	14.5%	5.7	21.0%	9.8	31.6%	15.5	52.6%
Yugoslavia	3.0%	2.9%	0.2%	3.9	26.6%	3.6	22.8%	3.9	26.4%	2.9	18.2%	6.8	44.6%
Total	4.2%	3.7%	0.5%	78.3	17.7%	92.4	18.9%	103.4	24.1%	105.4	22.1%	208.8	46.2%
o.w. HICs	4.1%	3.7%	0.5%	76.9	19.0%	90.4	20.2%	101.2	25.6%	103.2	23.6%	204.4	49.2%

Country	IBRD Exposure as % of Total Debt 1990: w/o Scheme	with Scheme	IBRD Debt Service 1990 /b as % of X: w/o Scheme	with Scheme	as % Total DS: w/o Scheme	with Scheme	1989-1993 Average External Financing Requirements /d: Total	Financial Inst.	Fin. Inst Int. Savin
Argentina	5.5%	7.8%	3.1%	3.6%	6.5%	7.5%	2.2	0.4	212.2
Bolivia	3.9%	4.1%	4.7%	4.7%	9.0%	9.2%	0.5	0.0	na
Brazil	10.1%	12.7%	5.3%	5.5%	12.3%	13.2%	2.5	3.3	30.4
Chile	9.7%	10.6%	2.8%	2.9%	12.6%	12.9%	1.2	1.3	4.1
Colombia	27.3%	28.2%	9.5%	9.5%	23.2%	23.4%	1.5	0.0	na
Costa Rica	12.6%	19.9%	4.7%	5.0%	12.8%	15.1%	0.2	0.0	na
Cote d'Ivoire	19.9%	28.2%	9.0%	9.4%	20.4%	24.4%	0.6	1.0	24.5%
Ecuador	15.5%	21.4%	4.2%	4.5%	6.4%	7.0%	0.8	0.2	86.2%
Honduras	28.1%	33.0%	6.7%	6.8%	29.8%	33.4%	0.1	0.0	na
Jamaica	15.3%	16.9%	4.0%	4.1%	11.4%	11.7%	0.2	0.0	na
Mexico	12.0%	14.9%	4.4%	4.8%	12.8%	13.9%	4.5	2.0	48.6%
Morocco	17.8%	20.3%	5.8%	6.1%	21.3%	22.6%	0.3	0.0	na
Nigeria	13.0%	17.7%	6.2%	6.7%	18.5%	23.1%	1.0	0.0	na
Peru	6.7%	14.8%	19.5%	20.3%	39.1%	55.9%	1.4	0.6	106.0%
Philippines	15.6%	17.9%	5.1%	5.3%	22.0%	23.5%	2.4	0.8	24.7%
Poland	1.1%	1.4%	0.3%	0.4%	0.8%	0.9%	-3.0	na	na
Uruguay	12.5%	17.0%	3.8%	4.2%	13.9%	15.1%	0.2	0.1	44.3%
Venezuela	4.8%	7.6%	0.5%	0.8%	1.6%	1.7%	2.2	1.3	38.3%
Yugoslavia	16.5%	18.6%	4.4%	4.5%	26.2%	27.2%	-0.1	0.1	101.7%
Total	10.7%	13.4%	4.7%	5.0%	13.4%	14.7%	18.7	11.1	52.5%
o.w. HICs	11.4%	14.3%	4.9%	5.2%	14.1%	15.3%	21.6	11.1	47.4%

/a "Core" P.C. debt refer to standard definition of preferred creditor.
"Quasi" - preferred creditor debt refers to enhance bonds.
/b Interest Guarantee Funds are assumed to be disbursed into an escrow account.
/c Adjustments reflect funds diverted to other countries so as to limit the amount of debt reduced; funds added principally to Mexico and Venezuela.
/d External Financing Requirement is the sum of the Current Account Deficit and Reserve Changes (excluding the IMF). For Financial Institutions it is net flows.
/e Commercial Banks assumed to assign some value to the quasi-preferred status of the new bonds so that the exchange ratio averages 60.
/* Countries for which scheme would reduce 100% of commercial debt.

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Table 2: MULFORD NUMBERS \e

Country	Commercial MLT Debt end-1988 ($ million)	Secondary Market Price (cents)	IBRD Set Aside Adjustment Lending High Case: Remaining FY89	FY90-92	Update	Total	Adj /c	25% of Total	Additional IBRD Funds	IMF: Set Aside	IMF: Adtl. Funds
Argentina	45211	18	0	1287	0	1287	0	322	614	467	614
Bolivia	125	10	0	0	19	19	0	5	5	7	5
Brazil	67875	28	0	2688	0	2688	0	672	1039	975	1039
Chile	11845	56	0	0	300	300	0	75	98	109	98
Colombia	4819	51	0	165	0	165	0	41	55	60	55
Costa Rica	1731	15	0	0	150	150	0	38	78	54	78
Cote d'Ivoire	3937	17	0	642	0	642	-3	161	185	233	185
Ecuador	5374	13	0	118	48	166	0	42	97	60	97
Honduras	521	18	0	133	0	133	0	33	20	48	20
Jamaica	575	43	0	100	0	100	0	25	33	36	33
Mexico	65229	34	300	1821	1285	3406	0	851	1218	1235	1218
Morocco	4562	45	0	817	0	817	-65	204	263	296	263
Nigeria	11437	22	0	2236	0	2236	0	559	554	811	554
Peru	8668	6	0	0	200	200	-23	50	197	73	197
Philippines	12744	37	250	488	0	738	-1	184	261	267	261
Poland	12656	33	0	267	0	267	0	67	98	97	98
Uruguay	2389	58	140	112	0	252	-9	63	82	91	82
Venezuela	24817	28	0	450	700	1150	-234	288	451	417	451
Yugoslavia	7172	44	150	150	150	450	0	113	153	163	153
Total	291687	30	840	11474	2852	15166	-333	3792	5500	5500	5500
m.m. HICs	278510	29	840	11074	2852	14766	-333	3692	5382	5355	5382

Country	Buyback (IMF Set Aside): Exchange Rate	Debt Offered	% of Total	Debt Reduced	Interest Savings	Conversion: Exchange Rate debt/bonds	Volume of Debt Offered	% of Total	Int. Cvg. Years: IBRD	Int. Cvg. Years: IMF	Interest Savings	GDP USD bn
Argentina	23	2074	4.6%	1607	161	60	9406	20.8%	0.9	0.9	376	89.8
Bolivia	13	55	44.0%	48	5	42	70	56.0%	0.9	0.9	4	4.5
Brazil	34	2836	4.2%	1861	186	74	15933	23.5%	0.9	0.9	414	337.1
Chile	70	155	1.3%	47	5	88	1495	12.6%	0.9	0.9	18	20.2
Colombia	64	94	2.0%	34	3	86	843	17.5%	0.9	0.9	12	42.3
Costa Rica	18	300	17.3%	246	25	55	1196	69.1%	0.9	0.9	54	4.3
Cote d'Ivoire	21	1096	27.8%	863	86	59	2841	72.2%	0.9	0.9	116	10.2
Ecuador	16	371	6.9%	311	31	49	1489	27.7%	0.9	0.9	76	6.6
Honduras	23	215	41.3%	167	17	60	306	58.7%	0.9	0.9	12	4.5
Jamaica	53	68	11.9%	32	3	84	507	88.1%	0.9	0.9	8	3.2
Mexico	42	2927	4.5%	1692	169	80	18671	28.6%	0.9	0.9	373	184.8
Morocco	56	527	11.5%	231	23	85	4035	88.5%	0.9	0.9	61	19.1
Nigeria	28	2948	25.8%	2138	214	67	8489	74.2%	0.9	0.9	280	29.0
Peru	7	1055	12.2%	982	98	29	3025	34.9%	0.9	0.9	215	9.9
Philippines	46	578	4.5%	311	31	81	3994	31.3%	0.9	0.9	76	41.2
Poland	41	238	1.9%	141	14	78	1500	11.8%	0.9	0.9	33	54.1
Uruguay	73	126	5.3%	35	3	88	1256	52.6%	0.9	0.9	15	12.3
Venezuela	35	1192	4.8%	775	77	73	6909	27.8%	0.9	0.9	187	60.6
Yugoslavia	55	295	4.1%	132	13	84	2350	32.8%	0.9	0.9	38	55.2
Total	39	17152	5.9%	11652	1165	76	84314 u	28.9%	0.9	0.9	2368	983.8
m.m. HICs	36	16699	6.0%	11344	1134	75	82508 0	29.6%	0.9	0.9	2063	930.1

Country	Interest/GDP 1990: w/o Scheme	with Scheme	Reduction	Preferred Creditor Debt w/o Scheme 1988: USD bn	% Total	1990: USD bn	% Total	with Scheme "Core" PC /a: USD bn	% Total	"Quasi" /a: USD bn	% Total	Total PC: USD bn	% Total
Argentina	5.2%	4.7%	0.5%	8.0	14.3%	9.8	16.8%	11.0	20.8%	9.4	16.5%	20.4	37.3%
Bolivia	4.7%	4.5%	0.2%	1.7	42.1%	2.1	42.3%	2.2	43.2%	0.1	1.4%	2.2	44.6%
Brazil	2.6%	2.5%	0.2%	13.9	15.4%	13.3	14.7%	15.4	18.2%	15.9	18.0%	31.3	36.2%
Chile	8.1%	8.0%	0.1%	3.6	22.2%	3.7	23.3%	3.9	24.8%	1.5	9.5%	5.4	34.3%
Colombia	2.5%	2.5%	0.0%	6.1	42.4%	6.5	42.8%	6.6	44.0%	0.8	5.5%	7.5	49.5%
Costa Rica	7.0%	5.4%	1.6%	1.1	30.1%	1.1	28.7%	1.3	40.5%	1.2	31.9%	2.5	72.4%
Cote d'Ivoire	7.7%	5.8%	1.9%	2.2	25.1%	2.6	26.1%	3.0	37.4%	2.8	30.9%	5.8	68.3%
Ecuador	9.0%	8.1%	0.9%	2.7	30.9%	3.5	43.0%	3.7	52.2%	1.5	19.1%	5.2	71.3%
Honduras	3.4%	2.9%	0.5%	1.4	56.8%	1.4	53.8%	1.4	62.3%	0.3	12.6%	1.7	74.9%
Jamaica	8.7%	8.4%	0.3%	1.6	47.2%	1.5	41.7%	1.6	45.0%	0.5	14.2%	2.1	59.1%
Mexico	4.4%	4.1%	0.3%	16.2	19.5%	17.2	18.9%	19.6	22.9%	18.7	20.8%	38.3	43.7%
Morocco	6.0%	5.6%	0.4%	5.0	26.5%	5.6	27.8%	6.1	31.7%	4.0	20.3%	10.2	52.0%
Nigeria	8.3%	6.5%	1.8%	3.3	11.2%	4.8	14.6%	5.9	21.2%	8.5	27.8%	14.4	49.0%
Peru	6.7%	3.5%	3.3%	0.0	ERR	2.4	15.4%	2.8	22.3%	3.0	20.6%	5.8	42.9%
Philippines	5.4%	5.2%	0.2%	6.4	26.4%	7.1	27.0%	7.7	30.7%	4.0	15.3%	11.6	45.5%
Poland	7.0%	6.9%	0.1%	0.0	0.0%	0.6	1.6%	0.8	2.2%	1.5	4.1%	2.3	6.3%
Uruguay	2.8%	2.7%	0.1%	0.9	29.8%	0.8	24.1%	1.0	30.5%	1.3	36.7%	2.3	67.2%
Venezuela	5.8%	5.4%	0.4%	0.3	1.1%	4.6	14.5%	5.5	18.9%	6.9	22.2%	12.5	41.1%
Yugoslavia	3.0%	3.0%	0.1%	3.9	26.6%	3.6	22.8%	3.9	25.6%	2.3	15.0%	6.3	40.5%
Total	4.2%	3.9%	0.3%	78.3	17.7%	92.4	18.9%	103.4	22.9%	84.3	17.7%	187.7	40.6%
m.m. HICs	4.1%	3.8%	0.3%	76.9	19.0%	90.4	20.2%	101.2	24.3%	82.5	18.9%	183.7	43.2%

Country	IBRD Exposure as % of Total Debt 1990: w/o Scheme	with Scheme	IBRD Debt Service 1990 /b as % of X: w/o Scheme	with Scheme	as % Total DS: w/o Scheme	with Scheme	1989-1993 Average External Financing Requirements /d: Total	Financial Inst.	Fin. Inst. Int. Savings
Argentina	5.5%	7.2%	3.1%	3.6%	6.5%	7.1%	[illegible]	0.4	134.2%
Bolivia	3.9%	4.1%	4.7%	4.8%	9.0%	9.2%	0.5	0.0	na
Brazil	10.1%	12.0%	5.3%	5.5%	12.3%	12.8%	2.5	3.3	18.2%
Chile	9.7%	10.4%	2.8%	2.9%	12.6%	12.7%	1.2	1.3	1.7%
Colombia	27.3%	27.9%	9.5%	9.5%	23.2%	23.3%	1.5	0.0	na
Costa Rica	12.6%	18.1%	4.7%	5.1%	12.8%	14.3%	0.2	0.0	na
Cote d'Ivoire	19.9%	27.2%	9.0%	9.5%	20.4%	23.6%	0.6	1.0	20.3%
Ecuador	15.5%	19.2%	4.2%	4.5%	6.4%	6.8%	0.8	0.2	53.5%
Honduras	28.1%	32.5%	6.7%	6.8%	29.8%	32.8%	0.1	0.0	na
Jamaica	15.3%	16.7%	4.0%	4.2%	11.4%	11.6%	0.2	0.0	na
Mexico	12.0%	14.2%	4.4%	4.8%	12.8%	13.4%	4.5	2.0	27.1%
Morocco	17.8%	20.0%	5.8%	6.1%	21.3%	22.1%	0.3	0.0	na
Nigeria	13.0%	17.3%	6.2%	6.8%	18.5%	22.0%	1.0	0.0	na
Peru	6.7%	9.9%	19.5%	.0.0%	39.1%	45.8%	1.4	0.6	52.2%
Philippines	15.6%	17.3%	5.1%	5.3%	22.0%	22.8%	2.4	0.8	13.4%
Poland	1.1%	1.4%	0.3%	0.4%	0.8%	0.8%	-3.0	na	na
Uruguay	12.5%	15.7%	3.8%	4.2%	13.9%	14.3%	0.2	0.1	18.5%
Venezuela	4.8%	6.8%	0.5%	0.8%	1.6%	1.7%	2.2	1.3	20.3%
Yugoslavia	16.5%	18.0%	4.4%	4.5%	26.2%	26.7%	-0.1	0.1	50.8%
Total	10.7%	12.8%	4.7%	5.0%	13.4%	14.2%	18.7	11.1	31.8%
m.m. HICs	11.4%	13.6%	4.9%	5.2%	14.1%	14.8%	21.6	11.1	28.8%

/a "Core" P.C. debt refer to standard definition of preferred creditor.
"Quasi" - preferred creditor debt refers to enhance bonds.
/b Interest Guarantee Funds are assumed to be disbursed into an escrow account.
/c Adjustments reflect funds diverted to other countries so as to limit the amount of debt reduced; funds added principally to Mexico.
/d External Financing Requirement is the sum of the Current Account Deficit and Reserve Changes (excluding the IMF). For Financial Institutions it is net flows.
/e Commercial banks assumed to value conversion bonds as if they were not senior debt.
/f Countries for which scheme would reduce 100% of commercial debt.

FRSCR:22Mar89

Table 3: MULFORD NUMBERS /e

Country	Commercial MLT Debt end-1988 ($ million)	Secondary Market Price (cents)	IBRD Set Aside Adjustment Lending High Case: Remaining FY89	FY90-92	Update	Total	Adj /c	25% of Total	Additional IBRD Funds	IMF: Set Aside	IMF: Adtl. Funds	Buyback (IMF Set Aside): Exchange Rate	Debt Offered	% of Total	Debt Reduced	Interest Savings
Argentina	45211	18	0	1287	0	1287	0	322	705	455	705	23	2023	4.5%	1568	157
Bolivia	125	10	0	0	19	.19	-4	5	3	7	3	13	54	42.9%	47	5
Brazil	67875	28	0	2688	0	2688	0	672	1052	951	1052	34	2767	4.1%	1616	182
Chile	11845	56	0	0	300	300	0	75	82	106	82	70	152	1.3%	45	5
Colombia	4819	51	0	165	.0	165	0	41	52	58	52	64	92	1.9%	33	3
Costa Rica	1731	15	0	0	150	150	-13	38	63	53	63	18	293	16.9%	240	24
Cote d'Ivoire	3937	17	0	642	0	642	-105	161	125	227	125	21	1070	27.2%	842	84
Ecuador	5374	13	0	118	48	166	0	42	133	59	133	16	362	6.7%	303	30
Honduras	521	18	0	133	0	133	-27	33	14	47	14	23	210	40.3%	163	16
Jamaica	575	43	0	100	0	100	-8	25	22	35	22	53	67	11.6%	31	3
Mexico	65229	34	300	1821	1385	3506	0	876	1222	1240	1222	42	2940	4.5%	1700	170
Morocco	4562	45	0	817	0	817	-66	204	177	289	177	56	514	11.3%	225	22
Nigeria	11437	22	0	2236	0	2236	-554	559	374	791	374	28	2877	25.2%	2085	209
Peru	8668	6	0	0	200	200	-33	50	334	71	334	7	1029	11.9%	958	96
Philippines	12744	37	250	488	0	738	0	184	253	261	253	46	564	4.4%	503	30
Poland	12656	33	0	267	0	267	0	67	96	94	96	41	232	1.8%	138	14
Uruguay	2389	58	140	112	0	252	0	63	77	89	77	73	123	5.1%	34	3
Venezuela	24817	28	0	450	979	1429	0	357	571	506	571	35	1445	5.8%	939	94
Yugoslavia	7172	44	150	150	150	450	0	113	146	159	146	55	288	4.0%	129	13
Total	291687	30	840	11474	3231	15545	-609	3886	5500	5500	5500	38	17100	5.9%	11600	1160
o.w. HICs	278510	29	840	11074	3231	15145	-582	3786	5390	5358	5390	36	16658	6.0%	11299	1130

Country	Conversion: Exchange Rate debt/bonds	Volume of Debt Offered	% of Total	Int. Cvg. Years: IBRD	Int. Cvg. Years: IMF	Interest Savings	GDP USD bn	Interest/GDP 1990: w/o Scheme	with Scheme	Reduction
Argentina	35	16124	35.7%	0.9	0.9	1048	69.6	5.2%	4.0%	1.2%
Bolivia	17	72	57.1%#	0.9	0.9	6	4.5	4.7%	4.5%	0.2%
Brazil	49	24062	35.5%	0.9	0.9	1227	337.1	2.6%	2.3%	0.4%
Chile	70	1880	15.9%	0.9	0.9	56	20.2	8.1%	7.8%	0.3%
Colombia	61	1189	24.7%	0.9	0.9	46	42.3	2.5%	2.4%	0.1%
Costa Rica	30	1438	83.1%#	0.9	0.9	101	4.3	7.0%	4.4%	2.6%
Cote d'Ivoire	34	2867	72.6%#	0.9	0.9	189	10.2	7.7%	5.1%	2.6%
Ecuador	24	3039	56.6%	0.9	0.9	231	6.6	9.0%	6.8%	2.3%
Honduras	35	311	59.7%#	0.9	0.9	20	4.5	3.4%	2.8%	0.7%
Jamaica	59	508	88.4%#	0.9	0.9	21	3.2	8.7%	8.1%	0.6%
Mexico	55	27955	42.9%	0.9	0.9	1258	164.8	4.4%	3.7%	0.7%
Morocco	60	4048	88.7%#	0.9	0.9	167	19.1	6.0%	5.2%	0.8%
Nigeria	42	8560	74.8%#	0.9	0.9	497	29.0	8.3%	5.7%	2.6%
Peru	7	7639	88.1%#	0.9	0.9	710	9.9	6.7%	3.5%	3.3%
Philippines	56	5777	45.3%	0.9	0.9	254	41.2	5.4%	4.9%	0.6%
Poland	53	2207	17.4%	0.9	0.9	104	54.1	7.0%	6.7%	0.2%
Uruguay	63	1754	73.4%	0.9	0.9	65	12.3	2.8%	2.3%	0.5%
Venezuela	48	13057	52.6%	0.9	0.9	679	60.6	5.8%	4.6%	1.2%
Yugoslavia	59	3345	46.6%	0.9	0.9	127	55.2	3.0%	2.8%	0.2%
Total	51	125834	43.1%	0.9	0.9	6812	988.8	4.2%	3.6%	0.7%
o.w. HICs	50	123315	44.3%	0.9	0.9	6166	930.1	4.1%	3.5%	0.7%

Country	Preferred Creditor Debt, w/o Scheme: 1988 USD bn	1988 % Total	1990 USD bn	1990 % Total	with Scheme: "Core" PC /a USD bn	"Core" PC /a % Total	"Quasi" /a USD bn	"Quasi" /a % Total	Total PC USD bn	Total PC % Total	IBRD Exposure as % of Total Debt 1990: w/o Scheme	with Scheme	IBRD Debt Service 1990 /b as % of X: w/o Scheme	with Scheme	as % Total DS: w/o Scheme	with Scheme	1989-1993 Average External Financing Requirements /d: Total	Financial Inst.	Fin. Inst. Int. Savings
Argentina	8.0	14.3%	9.8	16.8%	11.2	24.1%	16.1	28.3%	27.4	52.4%	5.5%	8.5%	3.1%	3.6%	6.5%	8.0%	2.2	0.4	361.2%
Bolivia	1.7	42.1%	2.1	42.3%	2.2	43.3%	0.1	1.4%	2.2	44.8%	3.9%	4.0%	4.7%	4.7%	9.0%	9.2%	0.5	0.0	na
Brazil	13.9	15.4%	13.3	14.7%	15.4	20.1%	24.1	27.1%	39.4	47.3%	10.1%	13.3%	5.3%	5.5%	12.3%	12.5%	2.5	3.3	42.7%
Chile	3.6	22.2%	3.7	23.3%	3.8	25.3%	1.9	11.9%	5.7	37.2%	9.7%	10.6%	2.8%	2.9%	12.6%	13.0%	1.2	1.3	4.7%
Colombia	6.1	42.4%	6.5	42.8%	6.6	45.0%	1.2	7.8%	7.8	52.8%	27.3%	28.5%	9.5%	9.5%	23.2%	23.6%	1.5	0.0	na
Costa Rica	1.1	30.1%	1.1	28.7%	1.3	46.2%	1.4	38.3%	2.7	84.5%	12.6%	20.5%	4.7%	5.0%	12.8%	15.4%	0.2	0.0	na
Cote d'Ivoire	2.2	25.1%	2.6	26.1%	2.9	39.3%	2.9	31.1%	5.7	70.5%	19.9%	29.0%	9.0%	9.4%	20.4%	24.9%	0.6	1.0	27.3%
Ecuador	2.7	30.9%	3.5	43.0%	3.7	68.2%	3.0	38.9%	6.8	107.1%	15.2%	25.3%	4.2%	4.6%	6.4%	7.3%	0.8	0.2	130.6%
Honduras	1.4	56.8%	1.4	53.8%	1.4	63.8%	0.3	12.8%	1.7	76.6%	28.1%	33.3%	6.7%	6.8%	29.8%	33.8%	0.1	0.0	na
Jamaica	1.6	47.2%	1.5	41.7%	1.5	46.0%	0.5	14.2%	2.1	60.2%	15.3%	17.0%	4.0%	4.1%	11.4%	11.8%	0.2	0.0	na
Mexico	16.2	19.5%	17.2	18.9%	19.7	25.5%	28.0	31.2%	47.6	56.7%	12.0%	15.8%	4.4%	4.8%	12.8%	14.4%	4.5	2.0	71.4%
Morocco	5.0	26.5%	5.6	27.8%	5.9	32.5%	4.0	20.3%	10.0	52.9%	17.8%	20.6%	5.8%	6.0%	21.3%	23.0%	0.3	0.0	na
Nigeria	3.3	11.2%	4.8	14.6%	5.5	21.5%	8.6	28.0%	14.1	49.5%	13.0%	18.0%	6.2%	6.6%	18.5%	24.0%	1.0	0.0	na
Peru	0.0	ERR	2.4	15.4%	3.1	40.4%	7.6	51.9%	10.7	92.3%	6.7%	18.2%	19.5%	20.3%	39.1%	63.1%	1.4	0.6	134.4%
Philippines	6.4	26.4%	7.1	27.0%	7.6	32.4%	5.8	22.1%	13.4	54.6%	15.6%	18.5%	5.1%	5.3%	22.0%	24.2%	2.4	0.8	35.6%
Poland	0.0	0.0%	0.6	1.6%	0.8	2.2%	2.2	6.0%	3.0	8.2%	1.1%	1.4%	0.3%	0.4%	0.8%	0.9%	-3.0	na	na
Uruguay	0.9	29.8%	0.8	24.1%	1.0	35.6%	1.8	51.3%	2.7	86.8%	12.5%	18.3%	3.8%	4.2%	13.9%	15.8%	0.2	0.1	68.3%
Venezuela	0.3	1.1%	4.6	14.5%	5.8	23.9%	13.1	42.1%	18.8	66.1%	4.8%	8.7%	0.5%	0.8%	1.6%	1.8%	2.2	1.3	59.5%
Yugoslavia	3.9	26.6%	3.6	22.8%	3.9	27.2%	3.3	21.3%	7.2	48.6%	16.5%	19.2%	4.4%	4.5%	26.2%	27.7%	-0.1	0.1	150.0%
Total	78.3	17.7%	92.4	18.9%	103.4	25.3%	125.8	26.4%	229.2	51.8%	10.7%	14.1%	4.7%	5.0%	13.4%	15.2%	18.7	11.1	71.8%
o.w. HICs	76.9	19.0%	90.4	20.2%	101.2	27.0%	123.3	28.2%	224.5	55.2%	11.4%	15.0%	4.9%	5.2%	14.1%	15.9%	21.6	11.1	65.7%

/a "Core" P.C. debt refer to standard definition of preferred creditor.
"Quasi" - preferred creditor debt refers to enhance bonds.
/b Interest Guarantee Funds are assumed to be disbursed into an escrow account.
/c Adjustments reflect funds diverted to other countries so as to limit the amount of debt reduced; funds added principally to Mexico and Venezuela.
/d External Financing Requirement is the sum of the Current Account Deficit and Reserve Changes (excluding the IMF). For Financial Institutions it is net flows.
/e Commercial Banks assumed to assign some value to the quasi-preferred status of the new bonds so that the exchange ratio averages 50.
/# Countries for which scheme would reduce 100% of commercial debt.

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Table 4: THE MULFORD NUMBERS - IMPACT OF EXCHANGE PRICE

Transactions Price Assumption /a		Volume of Old Debt Participating		Interest Coverage	Interest Reduction			Interest Reductions	
								% of Net Commercial	% of GDP
Buyback	Conversion	Buyback	Conversion	(Years)	Buyback	Conversion	Total	Requirements/b	1990
		<----$ billion---->			<-------$ billion------->				
30	45	18.3	146	1.7	1.3	8.0	9.3	85	0.9
35	50	15.7	132	1.7	1.0	6.6	7.6	69	0.8
40	55	13.7	120	1.7	0.8	5.4	6.2	56	0.6
45	60	12.2	110	1.7	0.7	4.4	5.1	46	0.5
50	65	11.0	101	1.7	0.6	3.5	4.1	37	0.4
55	70	10.0	94	1.7	0.5	2.8	3.3	30	0.3

/a In each case, the difference between the exchange price for the buyback and the debt conversion is assumed to be 15 cents. Note that this differs from the assumptions included in Tables 1-3 in which buyback price is in all cases set at 25% above the current secondary market price.

/b As % of average annual requirements 1990-93.

Note: Funds available:
1. Buyback - $5.5 billion
2. Defeasance - $3.8 billion (i.e., new bonds issued = $ 66 billion
3. Interest coverage - $11.0
   IMF - $5.5
   IBRD - $5.5

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ILLUSTRATIVE EFFECTS OF WORLD BANK INVOLVEMENT IN VOLUNTARY DEBT REDUCTION OPERATIONS

This note discusses the effect of using World Bank resources in support of voluntary debt reduction operations in highly indebted countries. We consider two alternative types of operations: lending for a buyback, and financing credit enhancement of an exit bond (lending to collateralize the principal and a roll-over guarantee of one year's interest payments). The objective of this note is twofold. First, to illustrate the cost and benefits of these operations relative to lending for general balance of payments support. Second, to compare the relative efficiency of these operations in providing debt relief to the debtor countries. As measures of these effects we look at how these operations affect the debtor's cash flow, the contractual interest payments to commercial banks, and the present value of the debtor's external obligations evaluated using its own discount rate (i.e., the wealth effect).

Throughout, we assume that the funds used for these operations are not additional, i.e., that the World Bank would reduce its "regular" lending program by the amount of funds committed to these operations. In order to illustrate our analysis we consider the effects of the operation for a country (referred to as HIC in this note) whose debt trades at a 60% discount in secondary markets. Also, for simplicity, we assume that in the absence of these operations, HIC would not be able to refinance any of the interest payments due. These assumptions are relaxed in the Annexes. Annex 1 shows how the results differ when additional Bank capital is allocated for these operations. In this case the debtor is obviously better off, as it attracts larger amounts of resources at an interest rate which is lower than the implied by the loans that are being retired. In Annex II, we discuss how the assumptions on the degree of interest refinancing and on the secondary market price of existing loans affect the returns of these operations, as well as their relative efficiency.

Lending for Buy-backs

We assume that the Bank lends HIC US$100 to be used in a buy-back of part of its commercial debt outstanding. A buy-back consists of pre-paying part of HIC's commercial debt at a discount. In order to pursue this operation, HIC would have to seek waivers on prepayment and sharing clauses from all creditors, as was done by Bolivia and Chile before their recent buybacks. Once this is done, HIC can either offer a price (as Bolivia did), or call for bids (as Chile did). In either case, as long as the buy-back is small relative to the total debt, the price that HIC will have to pay is likely to be similar to the secondary market price for its public sector debt, 40% of its face value in our example.

The results of the buy-back are presented in Table 1. At a price of 40%, HIC would be able to buy-back US$250 of its outstanding external debt, using the US$100 loan from the World Bank. Assuming an average interest rate on the retired loans of about 10%, this would lead to an annual reduction in contractual interest payments of US$25. However, such an operation would have a negative cash flow effect of US$75 in the first year, since the World Bank loan would not be available to finance other balance of payments requirements. In the following years, the cash flow relief due to the buy-back would be US$25, identical to the reduction in interest payments.[1] In addition, the buy-back would eliminate the need to repay the principal of the loan at maturity (which in our calculations we assume would be rescheduled to 30 years).

Financing Credit Enhancement of Exit Bonds

An alternative way for the World Bank to support voluntary debt reduction operations is to finance credit enhancement for an issue of exit bonds. Exit bonds are instruments designed to provide creditor banks with the option of accepting a lower contractual return, in exchange for some form of credit enhancement and an exemption from lending new money. For example, within the framework of the 1988 financing package, Brazil exchanged US$1 billion of 6% convertible exit bonds for the same amount of commercial bank loans. The Mexican exchange of bonds for loans had similar objectives, although it was not done in the process of negotiating new loans. Some highly indebted countries (e.g., Chile and Mexico) would not be required to seek waivers from its commercial creditors for this type of operation, since exchanges of debt are allowed under their current restructuring agreements. This represents an immediate benefit of guaranteed exit bonds over buy-backs.

Again, we assume that the World Bank diverts US$100 from its "regular" lending program towards providing credit enhancement for an issue of 30 year, collateralized, 5% exit bonds. The exit bonds have to be designed in a way that makes the present value of the Bank's maximum exposure under this option also equal to US$100. We assume that the Bank lends HIC the funds needed to purchase a 30 year, zero coupon bond which HIC uses to collateralize the exit bond. In addition the Bank would provide HIC with a roll-over guarantee covering one year's interest payments. Assuming a market interest rate of 10% for both short and long maturities, the collateral would cost 5.7% of the face value of the exit bonds and the interest guarantee 4.5%. Hence, an allocation of US$100 of Bank capital would be enough to provide credit enhancement for an issue

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1/ Since the World Bank loans are assumed to come out of the existing program, interest payments on it are not included, as they would have been incurred in any case. In our calculations we assume that the diverted loans would have financed infra-marginal expenditures. Otherwise, the initial negative cash flow effect would be avoided, since the demand for imports would have fallen by the same amount as the diverted loan.

of approximately US$1000 of exit bonds[2], a loan for US$573 to purchase the collateral and the remainder for the interest guarantee.

The terms of the exchange of the old loans for the exit bonds depend on the value that creditor banks ascribe to the bonds relative to the loans. This value depends on several factors: the value that banks ascribe to the ascribe to the World Bank guarantee, the value banks ascribe to the exemption from new money, and possible tax and regulatory benefits. In our calculations we assume that banks value the collateral and the guaranteed year of interest payments at their cost to the debtor, i.e. a total of US$100. In addition, the Bank guarantee is likely to provide the exit bonds with some degree of seniority over existing loans. This would occur because the guarantee would link, either explicitly or implicitly, the servicing of the exit bonds to the World Bank's relationship and expected lending to HIC. The degree to which this would occur depends on the specific structure of the guarantee. This effect, referred to as the "umbrella effect", is larger, the stronger the linkages between the exit bonds and the World Bank lending program. The umbrella effect can also be expected to be stronger in countries where the Bank has relatively more leverage. The umbrella effect enables some leverage in the use of Bank resources relative to the buy-back.

In the absence of the umbrella effect, creditor banks would look at the non-collateralized/non-guaranteed portion of the exit bonds as unchanged HIC credit risk, and will use a rate of discount to evalute future payments on the bonds similar to the one they use to evalute payments on existing loans, as was the case in the recent Mexican exchange offer.[3] Under these circumstances, the rate of return for HIC in the use of Bank resources in either a buyback or an exchange would be very similar. On the other hand, linkages to the Bank would confer the exit bonds a "quasi-preferred" status (the umbrella effect) and reduce their riskiness relative to existing loans. This would, therefore, reduce the discount rate that banks use to evalute future payments on the non-guaranteed part, and would increase the returns to HIC per dollar of resources provided by the Bank. The stronger the linkages to the Bank, the lower the discount rate on the non-guaranteed portion, and hence the larger the leverage in the use of Bank resources. Throughout, we assume that the guarantee does not erode the Bank's status itself. This is in line with our previous assumption that these operations are relatively small, and that they are not additional but substitutes for other Bank loans.

The regulatory and tax environments in which commercial banks operate may influence the effects of both types of operations. Clearly, creditor countries could use tax and regulatory policies to create incentives for voluntary debt reduction operations, and hence increase

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2/ Actually, these resources are enough for only US$973 of exit bonds, but to simplify the presentation we use US$1000 instead.

3/ Otherwise there would be arbitrage possibilities between the exchange offer and the secondary market. See R. Lamdany, "Voluntary Debt Reduction: Bolivia, Mexico and Beyond" World Bank Discussion Paper No. 42. November 1988.

the returns to the use of Bank resources in such operations.[4] Regulatory policy creates incentives for banks by determining the extent to which a bank's capital must be allocated to different financial instruments. All others things being equal, banks have an incentive to hold the financial instrument which requires the least amount of regulatory capital. Tax policy creates important incentives for banks by defining the extent to which losses are shared with the public sector.[5]

While some regulatory and tax policies could faciliate both buybacks and exchange offers, it would probably be easier to find policies which faciliate exchange offers, due to the ability of banks that accept reduced rate loans or bonds to delay the recognition of capital loss. In terms of regulatory policy creditor governments could more rigorously enforce existing regulatory structures which require assets to be written down when the country is in a protracted state of arrears and payments are not likely to be resumed. A quicker write down of assets when the country is in arrears might provide some incentive for banks to participate in voluntary debt reduction. This would be particularly true where the regulatory treatment of assets received by banks in voluntary debt reduction operations is more favorable than the treatment of arrears. In the case of buybacks the loss for regulatory (and tax) purposes must be recognized immediately. In the case of exchange offers, where existing loans are exchanged for assets with a reduced rate of interest, accounting and regulatory policies exist which would allow banks to retain that asset at its full face value on their books, recognizing their capital loss over time in the form of reduced income.[6] This regulatory treatment of voluntary debt reduction could be combined with a tax policy which allowed banks that participate in voluntary debt reduction to recognize the tax deduction "upfront," eventhough they are recognizing the capital loss over a number of years.[7]

In the present example we have assumed that the "Quasi-preferred" creditor status of the exit bonds would lead commercial banks to reduce the discount rate applied to evaluate the non-guaranteed claims from 25% to 17.5% (the yield implied by loans trading at a market price of 60%). Under this assumption the secondary market cash value of the proposed bonds would be about 40% of their face value, which coupled with the formal exemption from new money and with any tax regulatory benefits, should be enough to attract the necessary number of banks to subscribe all the US$1000 of guaranteed exit bonds issued by HIC.

4/ However, it is important to keep in mind that tax and regulatory changes designed to create incentives for voluntary debt reduction will usually have costs either in terms of decreased tax revenue or increased risk for the financial system.

5/ These issues are discussed in further detail in the "Some Potential Tax Regulatory, and Accounting Issues Affecting Debt Restructuring", Jonathan Hay, DFS Working Paper, World Bank, March 1989.

6/ The Brazilian exit bonds, for example, qualified for this type of treatment in the United States.

7/ In this note we have not explicetly taken into account these effects. For a A detailed discussion of these issues see "Mexico: Alternative Strategies for Medium Term Financing", Debt Management and Financial Advisory Services, February 1989.

The effects of the exchange on HIC's debt service are presented in Table 1. Assuming that the full US$1000 are subscribed, the exchange would lead to an annual reduction in contractual interest payments to commercial banks of US$50 (again, assuming an interest rate on the old loans of 10%). The effects of the exchange on HIC's cash flow have to take into account the change in cash flows with the World Bank. As with the buy-back, this leads to a negative cash flow of US$50 in the first year (due to the fall of US$100 in World Bank disbursements). In the following years, the exchange would render a positive cash flow equal to the reduction in interest payments to commercial banks, US$50 per year.[8]

Assessment of the Operations.

Table 2 summarizes the benefits from each operation from HIC's point of view. The buyback has an internal rate of return of 25%, and reduces the present value of HIC's future contractual debt service payments by between US$230 and US$150 (for discount rates of 10% and 15% respectively). The benefits of the exit bond are even larger, providing debt service reduction of between US$280 and US$430 and a rate of return of over 50%. The cash flow effect of both operations is negative in the first year, but turns positive thereafter. The present value of the cash flow effects turns positive after only a couple of years for the guaranteed bonds, while for the buyback may take over six years. In the annex we show that the benefits from these operations for the debtor increase as the secondary market discount rises, but are smaller when the debtor is able to refinance part of the interest payments due on the old loans rather than making the interest payments.

World Bank financed voluntary debt reduction operations can be a cost effective way of supporting adjustment programs in highly indebted countries. Such operations would also facilitate their negotiations with creditor banks. Whether such operations would be enough to eliminate the debtors' need for additional new money loans depends on the amounts of support the Bank (possibly in conjunction with other official creditors) would be willing to provide.

From the World Bank point of view it is important to analyze the effects of both operations on the quality of Bank's portfolio. World Bank supported voluntary debt reduction operations have two off-setting effects on the quality of the Bank's portfolio. On the one hand, they increase the World Bank's share in HIC's total indebtedness as well as the total amount of quasi-preferred debt (which may dilute the Bank's preferred creditor status). On the other hand, these operations reduce

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8/ Interest payments to the World Bank decrease, since in this case the initial US$100 loan is not disbursed at all. On the other hand, World Bank disbursements would fall to compensate for the increase in exposure, due to the corresponding increase the present value of the principal guarantee. The two effects approximately off-set each other, as long as the interest rate on the Bank loans is similar to the discount rate used to evaluate the Bank's exposure under the guarantee. For simplicity, we have disregarded the effects of the guarantee fees, as they would be small relative to the total cash flow effects.

HIC's total debt, which would facilitate the servicing the remaining debt, including the World Bank's.

TABLE 1

Near-term Cash Flow Effects of Voluntary Debt Reduction Operations

Supported by the World Bank[a/]

(in US$)

	1989	1990	1991
$100 for a Buyback (of $250 of loans)			
Interest Savings	+ 25	+ 25	+ 25
Reduction in WB disbursements	-100	-	-
Net Cash Flow Effects	- 75	+ 25	+ 25
$100 Guarantee on Exit Bonds b/			
Commercial Bank Debt Service Savings	+ 50	+ 50	+ 50
Reduction in WB Disbursements	-100	- 10	- 10
Reduction in Debt Service to WB		+ 10	+ 10
Net Cash Flow Effects	- 50	50	50

a/ The figures represent the incremental effects of each operation relative to a situation in which the World Bank disburses a loan for $100.

b/ $100 in present value terms. Assumes full guarantee on principal of $1000 due in 30 years, plus 1 year's rolling interest guarantee (at an interest rate of 5%). The bonds are exchanged at par.

TABLE 2

Overall Effects of Voluntary Debt Reduction

Operation Supported by the World Bank[a/]

Rate of	Present Value of Debt Service Savings	Present Value of Cash Flow 3 years	Present Value of Cash Flow 6 years	Internal Return
$100 for a Buyback (of $250 of loans)				33%
10% Discount Rate	230	- 30	10	
15% Discount Rate	150	- 40	0	
$100 Guarantee on Exit Bonds b/				50%
10%	430	20	110	
15%	280	10	80	

a/ The figures represent the incremental effects of each operation relative to a situation in which the World Bank disburses a loan for $100.

b/ $100 in present value terms. Assumes full guarantee on principal of $1000 due in 30 years, plus 1 year's rolling interest guarantee (at an interest rate of 5%). The bonds are exchanged at par.

Annex: The Effects of Refinancing and Different Secondary Market Discounts.

This Annex discusses the effect of changing two of our assumptions would have on the results presented in the main text. First, we look at the same example, but we assume that 20% of interest payments on the old debt would be refinanced in the absence of the voluntary debt reduction operations. Second, we look at a different debtor (referred to as HIC2 in this annex) whose debt trades in the secondary market at 15% of its face value. In addition, we assume that 60% of HIC2's interest payments are automatically capitalized, which to some extent explains the larger discount. Tables A.1 and A.2 summarize the corresponding results.

The effects of refinancing part of HIC's interest payments.

We make the same assumptions as in the main exit, except that 20% of each year's interest payments due on the old loans are refinanced at the same interest rate as the loans. In Table A.1 we see that the initial cash flow effects of both options deteriorates further when 20% of the service on the old loans was refinanced. In this case, it takes over 5 years for the present value of both operations' cash flow to turn positive. In spite of that, the overall effect of voluntary debt reduction operations are still highly beneficial for the debtor, as is shown by the large internal rates of return for both operations (22% for the buyback and 35% for the exit bonds), and by their large wealth effect ($140 for the buyback and $250 for the exit bonds).

Voluntary Debt Reductions in HIC2.

Table A.2 presents the effects that a buyback or an exchange of loans for exit bonds would have for a debtor country like HIC2. As mentioned before, HIC2 is characterized as a country whose debt is trading at 15% of its face value. Furthermore, we assume that 60% of HIC2's interest payments on the old debt are automatically capitalized at the same interest rate as the old loans, and that the principal on the loans (including capitalized interest payments) is paid after 50 years. HIC2 could also serfe to illustrate the case of a country making partial interest payments (equal to 40% of the amounts due) and accumulating arrears for the rest.

Under these assumptions, HIC2 would be able to buyback over $666 of old loans, using the proceeds of the $100 World Bank loan. The present value of debt service savings as well as the internal rate of return of the buyback are even higher than in the case of HIC. However, the buyback would once again have an immediate negative cash flow effect, which for a country like HIC2 could be even more problematic than for HIC. The present value of the cash flow turns positive only after the sixth year, when evaluated using a discount rate of 20%, which seems appropriate for a country with the liquidity constrains of HIC2.

Alternatively, we assume that the Bank provides HIC2 with a partial guarantee over $1000 of exit bonds similar to those described in the main text for HIC. In this case the cash price of the exit bonds would be between 25% and 30% of their face value (assuming a market discount rate on the non-guaranteed part of between 21% and 26%, compared with an implied discount rate on existing loans of over 60%). Table A.2 presents the effects of the exchange assuming a market price for the bonds of 25%., i.e. the price that leads to an internal rate of return on the operation similar to that of the buyback. Under these assumption, banks would exchange $1667 in loans for the $1000 of exit bonds, leading to a reduction in HIC2's nominal debt of $667. As can be seen in table A.2 the cash flow effect is slightly worse than under the buyback over the first 3 years, and better thereafter. The present value of total savings is larger under the exchange than under the buyback.

Assessment

This annex shows that the benefits from these operations for the debtor, as well as the leverage in the use of the Bank's resources, increases with the secondary market discount. On the other hand, the benefits for the debtor are smaller when it is able to refinance a share of the interest payments due on the old loans, since such possibility increases the immediate negative cash flow effect and decreases the long run wealth effect of both operations.

In addition, the examples show in a simple manner how the relative efficiency in the use of Bank's resources in buybacks and in guarantees of exit bonds in reducing a country's debt burden depends on several parameters:

- the effect of the Bank guarantee on the discount factor that creditors use to evaluate the non-guaranteed part of exit bonds,
- the proportion of interest payments being refinanced on the old debt,
- the secondary market price of the old debt, and
- the effect of the Bank guarantee on the debtor's discount factor, i.e. its subjective probability of repayment.

Partial guarantees of exit bonds are likely to be more efficient than lending for buybacks in providing debtors with debt service relief, for a given increase in World Bank exposure. This proposition depends critically on the effect that the Bank guarantee has on the discount rate that creditors use to evaluate the non-guaranteed part, i.e. the efficiency of guarantees increases as this rate falls relative to the discount rate on implied by the secondary market price of existing loans.[9] The Bank guarantee lowers this rate by conferring certain degree of seniority to the exit bonds, as it explicitly or implicitly links them to the Bank's overall relationship with the debtor. Hence, the efficiency of guarantees on exit bonds (relative to buybacks) increases as a direct function of the Bank's leverage over the debtor (the size of future expected World Bank linked transfers), but decreases with the amount of exit bonds relative to the total debt. This implies that guarantees would be most efficient when applied to small amounts of exit bonds in the initial stages of debt reduction operations, and when relatively small proportions of the Bank's lending program is diverted toward debt reduction operations.

9/ It is important to realize that from the debtor's point of view, this leverage is beneficial only as long as the effect of the guarantee on the creditor's discount factor is larger than the effect on its own discount factor (which are proportional to the effects on the corresponding perceived probability of repayment).

As mentioned before, the benefits from both operations fall when in their absence the debtor would have been able to refinance part of its interest paymends. The larger the potential for refinancing, the smaller the benefits. This effect is more pronounced with the exit bonds than with the buyback, since the leverage of the guarantees is basically due to the protection that they provide against refinancing of the non-guaranteed part.

The efficiency of both operations (vis a vis regular lending) is larger for debtors whose loans trade at lower prices, other things being equal. Lower secondary market prices also reduce the efficiency of guarantees on exit bonds relative to lending for buybacks. This occurs because lower prices imply a lower market value for the non-guaranteed part of the exit bonds, again other things being equal.[10] Hence, increasing the share of the guaranteed part in the total value of the new instruments, and consequently making the exchange of loans for bonds more similar to a buyback. In addition, at lower prices the "market terms" of an exchange become more uncertain (due to the larger range of possible market discount rates for the unguaranteed portion of the exit bond). Therefore, it becomes more likely that a Bank guarantee would raise the debtor's perceived probability of repayment by more than it increases the perception of the creditors, which as we have suggested above may worsen the effects of the operation from the debtor's point of view.

10/ The relative efficiency of these operations would be unchanged if lower prices would not affect the discount rate the market uses to evaluate the non-guaranteed portion of the exit bonds.

TABLE A.1

Effects of Voluntary Debt Reduction Operations
Supported by the World Bank

Assumptions: 20% refinancing of interest payments.
Secondary price of 40%.

		1989	1990	1991
$100 for a Buyback (of $250 of loans)				
Reduction in Interest Paid to Banks		+ 20	+ 20	+ 21
Reduction in WB disbursements		-100	-	-
Net Cash Flow Effects		- 80	+ 20	+ 21
Present Value of a/ Debt Service Savings	140			
Present Value of Cash Flow Effects				
3 Years	-50			
6 Years	-20			
Internal Rate of Return	22%			
$100 Guarantee on Exit Bonds b/				
Reduction in Interest Paid to Banks		+ 30	+ 32	+ 33
Reduction in WB Disbursements		-100	- 10	- 10
Reduction in Debt Service to WB			+ 10	+ 10
Net Cash Flow Effects		- 70	32	33
Present Value of a/ Debt Service Savings	250			
Present Value of Cash Flow Effects				
3 Years	-20			
6 Years	+20			
Internal Rate of Return	35%			

a/ All present values are calculated using a 15% rate of discount.

b/ $100 in present value terms. Assumes full guarantee on principal of $1000 due in 30 years, plus 1 year's rolling interest guarantee (at an interest rate of 5%). The bonds are exchanged at par.

TABLE A.2

Effects of Voluntary Debt Reduction Operations
Supported by the World Bank

Assumptions: 60% refinancing of interest payments.
Secondary price of 15%.

		1989	1990	1991
$100 for a Buyback (of $666 of loans)				
Reduction in Interest Paid to Banks		+ 27	+ 28	+ 30
Reduction in WB disbursements		-100	-	-
Net Cash Flow Effects		- 73	+ 28	+ 30
Present Value of a/ Debt Service Savings	260			
Present Value of Cash Flow Effects				
3 Years	-30			
6 Years	+10			
Internal Rate of Return	32%			
$100 Guarantee on Exit Bonds b/				
Reduction in Interest Paid to Banks		+ 17	+ 21	+ 25
Reduction in WB Disbursements		-100	- 10	- 10
Reduction in Debt Service to WB		___	+ 10	+ 10
Net Cash Flow Effects		- 83	21	25
Present Value of a/ Debt Service Savings	370			
Present Value of Cash Flow Effects				
3 Years	-50			
6 Years	0			
Internal Rate of Return	32%			

a/ All present values are calculated using a 15% rate of discount.

b/ $100 in present value terms. Assumes full guarantee on principal of $1000 due in 30 years, plus 1 year's rolling interest guarantee (at an interest rate of 5%). The bonds are exchanged for $1667 of loans.

Buy-Back using $100 of diverted loans

1	2	3	4		5		6	7
Mkt. Disc	Change DOD	D.S. Reduction Annual	PV 10%	15%	PV of Cash Flow 5 years 10%	15%	Resour. per 100 DS red.	IRR
40%	167	17	157	109	-28	-31	600	20%
50%	200	20	189	131	-15	-20	500	25%
60%	250	25	236	164	4	-3	400	33%
70%	333	33	314	219	35	25	300	50%

1. Dicount: Discount on the buy-back.
2. Change in DOD: debt retired in the buy-back (assumes no additionality in official resources
3. D.S. Reduction: Annual reduction in interest payments to creditor banks.
4. Present value of reduction in interest payments to banks evaluated at 10% and 15% correspondingly
5. Cash Flow Effect: Present Value of Changes in the first 5 years Cash Flow due to the Buy-back.
6. Official Resources Required to Reduce annual debt service by $100 through a Buyback.

Exit Bond: Prices and Exchange Ratios

ısc.	*	Loan	*	Loans	*	Mid-Range	*	Bond Value		
	*	Price	*	Yield	*	Rate	*	12%	Mid-Rate	LoanYield
40%	*	60%	*	18%	*	15%	*	50	43	38
50%	*	50%	*	20%	*	16%	*	50	41	35
60%	*	40%	*	25%	*	19%	*	50	37	30
70%	*	30%	*	33%	*	23%	*	50	32	25

				Loans				Exchange Ratio		
Disc.				Yield				12%	Mid-Rate	LoanYield
40%	*	60%	*	18%	*	15%	*	0.84	0.72	0.64
50%	*	50%	*	20%	*	16%	*	1.00	0.82	0.70
60%	*	40%	*	25%	*	19%	*	1.25	0.92	0.75
70%	*	30%	*	33%	*	23%	*	1.67	1.07	0.84

Effects of Exchange Offer
(collateralized 30 year, 5% exit bond, with a World Bank roll-over guarantee covering 1 year's interest payments)

	12%		Mid Rate		Loan Yield	
MKT	10%	15%	10%	15%	10%	15%
Price	Present Value of Cash flow over 5 years					
30%	356	308			49	37
40%	203	173			18	9
50%	110	91			0	-7
60%	49	37			-25	-29

	12%		Mid Rate		Loan Yield	
	10%	15%	10%	15%	10%	15%
	Present Value of Cash flow over 5 years					
30%	1163	770			352	225
40%	758	498			271	171
50%	514	334			223	138
60%	352	225			158	95

	12%		Mid Rate		Loan Yield	
	IRR	D.S.	IRR	D.S.	IRR	D.S.
30%		114			0.58	32
40%		73			40%	24
50%	113%	49			31%	19
60%	58%	32			22%	13

DRAFT
NPaul/RBrun/SRajasingham:ai/mac
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IBRD SUPPORT FOR ALTERNATIVE DEBT REDUCTION TECHNIQUES

I. INTRODUCTION

1. This paper provides the background underpinning the operational guidelines for Bank involvement in debt reduction transactions. Two types of debt reduction mechanisms in particular seem promising at this time: buybacks and exchange offers. While the particulars of how debt reduction would take place are yet to be worked out, it is envisaged that proposals with regard to individual debt reduction transactions would be initiated by the borrower and its commercial bank creditors, and the Bank's participation in these transactions would be sought.

2. Section II explores the key objectives that would need to be met, and considerations that would guide Bank support of debt reduction, irrespective of the actual mechanisms. Section III looks at issues that are specific to the various mechanisms available for Bank support. Section IV briefly discusses Bank-Fund collaboration in the context of these transactions and Section V provides a summary of conclusions.

3. This paper is primarily concerned with setting out the differences between various mechanisms and the implications for Bank participation. It does not look at the broader question of whether Bank support of debt reduction transactions in a particular country is provided through diversion of resources from planned Bank lending to the country or whether it constitutes additional resources.

II. GENERAL CONSIDERATIONS FOR BANK SUPPORT OF DEBT REDUCTION

4. Irrespective of the size or type of transaction, Bank participation in debt reduction must only be encouraged when certain fundamental objectives for its support are met, and, if such support is to be forthcoming, ensure that the Bank's participation is in line with a set of overriding considerations. These objectives and considerations are set out below.

5. First, the participation of the Bank must be such that it provides a positive impetus to the developmental efforts of member countries engaged in implementing economic reforms. Hence, Bank support for debt reduction must be forthcoming for countries with a sustained record of implementing economic reform programs. Over and above this, however, support should also be provided as an incentive to strengthen the government's firm commitment to implement and continue reforms. Alleviation of the debt burden in the absence of economic reform would be an inefficient use of resources.

6. Second, the Bank's support of debt reduction operations must be predicated on achieving substantial financial relief for the debtor country. Hence, a "critical mass" of debt reduction[1] must be identifiable under a debt reduction transaction (or series of transactions) in a debtor country.[2] Debt reduction programs must be sufficiently far-reaching to appreciably improve the country's return to creditworthiness. Sustained development requires improved and continued access to finance rather than a curtailment of new finance from the international financial community as a consequence of inadequate debt reduction.

7. In order to ensure that transactions are carried out with due regard to these objectives, the final price negotiated between the borrower and the commercial creditors would be subject to Bank's concurrence. In according its assent, the Bank would be broadly guided by indicators such as the secondary market price and the country's ability to pay. In addition, the Bank would exercise its judgment in assessing the probable influence of the specific circumstances of the transaction on the exchange price. Furthermore, "arm's length" transactions would be the sine qua non of Bank's support. Transactions would be executed in a manner such that all commercial lenders would have equal opportunity to participate--either through a competitive bidding process, or on the basis of a fixed price. By the same token, special "Club" deals and transactions that seek to exclude potential participants to gain unwarranted benefits would be ineligible for Bank support.

8. To ensure that all potential transactions in each debtor country result in at least a minimum level of benefit to the debtor from the secondary market discount, a minimum threshold would be placed on the discount at which commercial debt is being transformed or retired. The threshold would apply generally to transactions in all debtor countries. It would define the point at which use of Bank capital for debt reduction is not competitive with other uses of Bank funds with regard to the benefit being provided to the debtor.[3] The threshold for Bank intervention will be presented for Board approval and thereafter would be reviewed periodically.

9. In supporting debt reductions, the Bank should also be cognizant of the free rider risks that exist, and seek to minimize the benefits of its participation to non-participating banks that wait out the process in order to exchange their debt at better terms. Obviously, it would be counterproductive to deny the benefits of improved debtor creditworthiness to creditors. Nevertheless, care should be taken to ensure that the Bank's resources are not used in the context of free-riding. Thus, it may be

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1/ The definition of "critical mass" is the subject of a separate analysis. Critical mass, for example, could be defined as the share of overall debt that is eliminated, the debt burden relief in terms of the economic activity in the country, or more simply as merely the improvement in financing requirements that needs to be achieved.

2/ The level of debt reduction that can be achieved is, however, limited by the amount of resources that can be deployed to facilitate debt reduction.

3/ Work on establishing a minimum threshold for Bank participation in debt reduction is proceeding separately.

necessary to limit both the range of prices as well as the period for which the debt reduction operation is available in instances where the Bank provides support.

10. On a more technical level, using direct cash outlays to support debt reduction must be carefully structured so that currency mismatches do not occur. Specifically, if the Bank were to lend in a mix of currencies to support a dollar amount of debt service obligations, it would take upon itself the burden of dealing with revaluation in the loan amount as a result of foreign exchange movements that could, over time, result in the debtor's obligation to the Bank becoming much larger than the protection being provided by the Bank. Particularly in the context of debt reductions, this could be a very sensitive issue.[4] For this reason, if cash disbursements are used for supporting debt reduction, they would need to be currency specific and, as is allowed under the new policies for currency management, be provided for separately from the funding of regular Bank loans.

III. SPECIFIC TYPES OF DEBT REDUCTION TRANSACTIONS

A. Bank Support for Exchange Offers

11. Bank support for exchange offers, whether through the use of guarantees or direct cash outlays can be of two types: long-term support--that is applicable to principal repayment obligations--and near-term support--for providing protection on interest payments as they come due. Each form of support, moreover, can be provided through either loans or guarantees.

(i) Long-Term support

12. Under extant guidelines, guarantees extended by the Bank are counted in full against country exposure limits at the time they become callable. As a broad rule of thumb, the present value of the guarantee is used to adjust planned lending in countries where special guarantee transactions are undertaken. In other words, the initial reduction in lending that would be necessitated by extending guarantees that have deferred call features is relatively small, but, over time, the full amount of the guarantee commitment would need to be taken into account, not only with regard to the lending program, but with respect to the Bank's statutory lending limit as well.

13. Alternatively, the Bank could extend a loan to finance[5] collateral instruments to defease the principal of new instruments under exchange offers. The amount of resources that would be required for the loan depends on the risk that is reflected in the collateral trust. The establishment of a trust consisting of high quality securities would cost more

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4/ With regard to the use of guarantees, this would not be a concern--the guarantee cover could be provided in the same currency as the underlying security or obligation.

5/ Or, if the country uses a portion of its international reserves for the purpose, to replenish the reserves.

than one which had securities with lesser ratings. If the trust were to be equipped with securities close to that of the Bank's own obligations, the resources to finance the collateral would be of the same order of magnitude as the present value of the Bank's exposure under a late maturity guarantee of principal. Hence, in terms of the impact on current lending plans, this mechanism would be similar to the late maturity guarantee initially. However, unlike in the case of guarantees, because the collateral trust can grow thereafter at a compounded interest rate independently, no adjustments would need to be made to the Bank's lending in subsequent years.

14. A third option would be for the Bank to guarantee repayment of principal, but charge the commercial lenders upfront a lump sum guarantee fee equal to the present value of the amount guaranteed. The proceeds would then be invested in collateral instruments. In this case, although the Bank has the contingent obligation of the guarantee, it has been pre-funded to the full amount of its contingent exposure, and hence the lending program to the country does not need to be adjusted at all to "make room" for the guarantee--the latter commitment could be simply added to the existing program.

15. It can be readily seen that the unfunded guarantee would require--over time--a larger reduction in the Bank's commitment authority than that required in the case of collateral trusts financed through direct Bank lending or through resources made available by commercial banks for pre-funded guarantees. Direct loans to finance collateral trusts and fully pre-funded guarantees are thus preferable to straight guarantees on long-term repayment of principal. Collateral trusts also allow debtors more flexibility in determining the resources that are spent in establishing support for principal repayment by varying the quality of assets included in the trust (which, within limits, may not have a significant effect on the exchange price).

16. It should also be recognized that if the Bank were to agree to a large amount of debt reduction, and no increase in the Bank's statutory lending authority were to be assumed, unfunded guarantees would need to be capped so that their face value would remain below the Bank's current lending limit, and taking into account future lending. With lending for collateral trust accounts this is not an issue--the cost of establishing the trust would be the sole charge against Bank capital. Similarly, under the pre-funded guarantee, the Bank's reserves and hence the statutory limit would grow at the same rate as its contingent commitment under the guarantee.

(ii) Near-term Support

17. As a policy matter, near-term Bank support for interest payments on commercial financing has been rarely provided by the Bank. The rationale for this is that commercial institutions should be able to manage short-term risk on obligations, and credit enhancement through Bank resources should only be used--when necessary--in the medium-to long-term portion of the financing. With regard to debt reduction, however, where the precepts of voluntary commercial finance are not valid, and where the increase in support on near-term flows can significantly increase the exchange ratio of the exchange offer, there could be grounds to provide near-term support on interest payment.

18. In any event, it would be inappropriate for the Bank to provide a full guarantee on interest payments at commercial rates. Doing so would make the exchange offer tantamount to a buyback, with no advantage to the Bank on the use of its capital. Partial guarantees can be structured either as rolling guarantees--whereby the extent of the Bank's support covers only one or two interest payments but, as payments are made, the cover "rolls" its subsequent payment obligations--or as diminishing guarantees where the Bank's support which begins at a fixed portion of the overall bond is gradually reduced as collateral that is used to defease principal grows over time. These mechanisms are considered below.

19. <u>Rolling Guarantees and Equivalent Interest Support</u>: The main advantage (as seen by the banks) of rolling guarantees is the general belief that the triggering of the Bank's guarantee in the event of non-payment, could in turn lead to the institution exercising other remedies against the borrower. These factors are perceived to act as a disincentive to the debtor to trigger a call on the guarantees and, because the guarantee continues to roll from payment to payment, the arrangement in effect enhances the entire stream of interest payments.

20. From the Bank's own standpoint, its legal obligation extends only to making payment on the guarantee amounts in the event of payment default. However, to the extent that pressure could be made to bear on the institution to avoid a triggering of the guarantee, the Bank's own lending and policy dialogue with the country may suffer. Overly circumscribing the attractiveness of the guarantee, on the other hand, may prove counterproductive to the debt reduction exercise because it would reduce the amount of debt reduction being obtained. Hence, guarantee agreements should be structured carefully to reduce the scope for such eventualities, yet keep the Bank closely linked to the transaction and thereby preserve the perceived value of the guarantee to the banks. Some of the concerns can be resolved in the guarantee agreement; for example the issues of subrogation--and the non-subordination of the Bank's claims, the non-reinstitutability of the guarantee once called, and the degree of linkages with other Bank lending, can be clearly set out in the initial agreement.

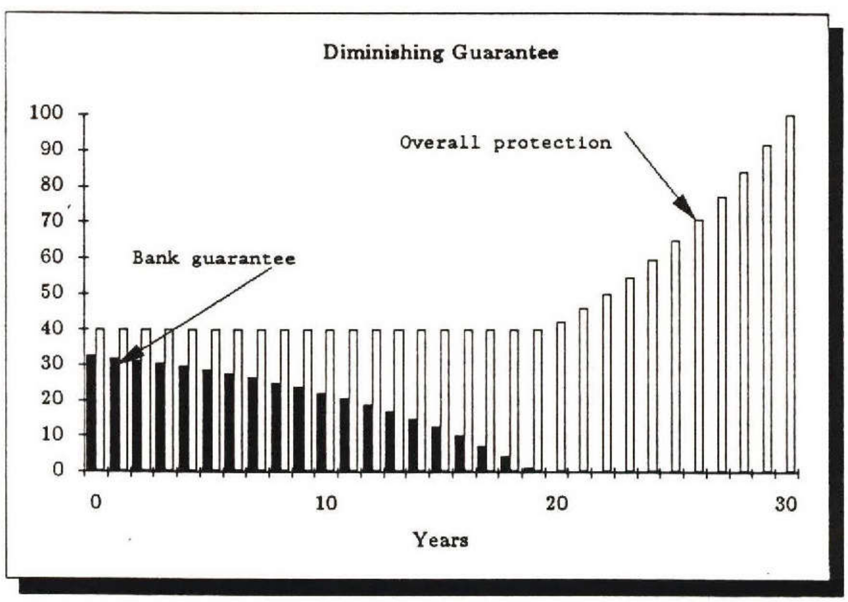
21. As an alternative to rolling guarantees on interest payments, escrow accounts financed by the Bank could be used to secure interest payments. Under such an arrangement, if interest payments are not met in a timely manner, funds could be drawn from the escrow account to meet the payment. Of course, conditions (linked to the Bank's own lending) calling on the borrower to replenish the escrow account for any amounts drawn down from it could be structured in the agreement thus making the mechanism somewhat onerous to the borrower, but providing additional comfort to the creditors. Alternatively, the Bank could stand away from the establishment and operation of the account. Again, the leverage in the mechanism must be balanced carefully against the attractiveness to the creditors; the absence of any conditions on drawdown/replenishment could reduce the attractiveness of the interest support mechanism, and thus reduce the leverage of the arrangement in providing for debt reduction.

22. From a fundamental standpoint, the basic exposure to the Bank is equivalent under the two arrangements. In either case, the underlying creditworthiness of the debtor and its ability to pay would be the dominant factors which would determine whether calls on the guarantee or disbursements from the escrow account would become necessary. And once disbursements have been made, the underlying risk with regard to recovery of those funds would be essentially the same under both cases.

23. Guarantees, however, have the advantage of affording greater flexibility to the Bank to manage its exposure over time. For example, specific contractual arrangements under a guarantee could permit the Bank to extend its support only for a specified period of time and then to withdraw that support. Under the escrow account arrangement, on the other hand, once disbursements under the Bank loan have been made and the escrow account established, the Bank would have less control over its duration and application.

24. The two arrangements could also have different cost implications for the debtor. Under the guarantee approach, the Bank would charge a guarantee fee to the creditors[6] that are beneficiaries of the guarantee (which may have a marginal affect on the price at which the debt is exchanged). In the escrow account arrangement, the debtor would bear the cost of the Bank loan used to establish the escrow, but would be able to earn interest on the funds in the escrow account. The net carrying cost on the escrow account depends on the cost of the Bank's loans and the return on its investment, but is likely to be at least 50 b.p. or so per annum.

25. <u>Diminishing Guarantees</u>: Under diminishing guarantees, the Bank would undertake to provide guarantees in conjunction with a collateral trust for eventual defeasance of principal. The guarantee would be structured so as to cover, along with the collateral, a minimum portion of the obligations. In a typical arrangement shown below, the minimum guarantee is for 40% of the principal. The obligation of the Bank gradually decreases to zero. The overall protection to the lenders remains at 40% until the Bank's guarantee is totally eliminated and then grows as the value of the collateral increases.



6/ In case the existing lenders (to whom the fee will be charged) reassign their assets, they would have to ensure that the liability to pay the fee is also assigned to the new bondholders; or else the Bank's obligation under the guarantee would lapse.

26. Payments under the guarantee can be arranged either sequentially, up to the amount of the guarantee, in response to payment failures on interest, or as a one time payment upon declaration of default and acceleration of the obligations. With regard to the entanglement question, the latter arrangement is favorable since it pays out the creditors in one action, and allows the Bank to pursue its indemnification with the borrower on its own terms. In any event, the subrogation agreement on the guarantee should be structured so as to not subordinate the Bank's claim as a result of payment under the guarantee, to claims of other lenders.

27. A key advantage of the diminishing guarantee is that it provides a mechanism for the Bank's exit to take place without having a detrimental effect on the credit enhancement being provided. Moreover, the protection is high upfront where uncertainty and "systematic entropy" regarding concepts of debt reduction (that are untested at this time) are very significant factors, but drops off gradually as the mechanisms continue to function.

28. The very nature of the diminishing guarantee makes it difficult to duplicate through the use of direct Bank disbursements. The unique characteristic of the guarantee, that allows the claim on the Bank at any given time to be adjusted to provide only the required cover, would be harder to control in the context of an escrow account.[7]

B. Bank Support for Cash Buybacks

29. Cash buybacks of existing debt provide a mechanism that allows debtors to liquidate their existing liabilities in part or in full, in contrast to exchange offers under which the lenders' exposure subject to the exchange--although enhanced in terms of credit quality--is not completely extinguished.

30. Bank financing of buybacks would be the simplest and most straightforward mode of support for debt reduction. Unlike guarantees and other mechanisms discussed above, there would be no legal or other linkage between the Bank and commercial lender. However, if buybacks were to be executed on a significant scale in relation to the level of outstanding debt, the Bank's share of the total exposure would increase dramatically. Although the total debt would be reduced by the amount of the discount achieved, it would predominantly consist of preferred creditor (particularly, the Bank) debt. Thus, while the Bank's portfolio risk is increased as a result of this larger share of the exposure, the underlying creditworthiness of the country has been improved by virtue of its lower debt service obligations.

31. For these reasons, the Bank's support for buybacks should be limited to those debtor countries where the size of commercial bank debt is small and the market discount on debt large, except, of course, when a significant level of resources from other sources are also being used for

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7/ While arrangements could be made to ensure the disbursement under the account was diminishing, the exposure to the Bank that would have been created when the escrow account was established, would not be reduced on time.

debt reduction. In other words, the Bank's support should be extended to "clean the slate" with use of reasonable resources and where the increase in the share of the preferred creditor debt is more than compensated for by the reduction in overall debt service. Even in these cases, the Bank should limit its share of a comprehensive buyback to a maximum of 50% of the overall effort to ensure that its exposure in relation to the overall debt of the country does not become overwhelmingly disproportionate.

32. Finally, to the extent possible, buybacks in each eligible country should be executed as a one-time operation. This would help in addressing the problem of free riders who would tend to "hold out" initially in order to benefit from potentially higher buyback prices that may result under subsequent transactions in an ongoing program of debt reduction. For the same reason, Bank resources should not be made available for buyback programs that operate continuously and are designed to absorb debt out of the market over time. The Bank would not, of course, prevent debtors from setting up such programs with other resources including their own reserves, provided they can secure the needed waivers.

IV. COLLABORATION BETWEEN THE BANK AND THE IMF ON DEBT REDUCTION

33. There is considerable scope for a joint effort in fostering debt reduction between the Bank and Fund in the context of the mechanisms discussed above. With regard to defeasing principal, the Bank and the Fund could jointly contribute toward the collateral trust. Similarly, for escrow accounts established for interest support, the Bank and Fund can both provide financing.

34. For mechanisms that use a combination of direct lending and guarantees, the Bank would have to deal with the guarantee portion of the transaction and may or may not be involved in the direct financing portion. In an exchange offer that consists of principal defeasance and a rolling guarantee, for instance, the Bank could provide the guarantee while the principal defeasance is provided by the Fund (for example, on a 25-year bond, the resources needed to defease the principal would be equivalent to the resources needed to guarantee a year's worth of interest payments). A similar arrangement could be used for the diminishing guarantee: the Fund could provide the resources needed for the collateral trust while the Bank provides the resources for the guarantee.

35. If the debt reduction process is to be tightly controlled and the discounts on the debt exchange are to be maximized, it is important that the efforts of the Bank and the Fund (and other resources that might be made available for this purpose) are carefully coordinated. An "excess supply" of resources for debt reduction--that could be caused by an uncoordinated effort--would benefit commercial creditors alone.

V. SUMMARY OF CONCLUSIONS

(i) In providing debt reduction, the Bank should seek to minimize its entanglement with commercial banks, but at the same time, providing a reasonable level of support to effect an acceptable level of debt reduction [to be defined].

(ii) Any transaction that the Bank enters into should be above a minimum threshold established for using its capital for debt reduction.

(iii) The debt reduction mechanisms for which Bank support is provided must be be arrived at through "arm's length" transactions that provide for competitive bidding and reflect prices that are close to the secondary market levels.

(iv) Bank support for principal repayment of exit bonds should be provided through direct financing of collateral for defeasance or through guarantees which are fully pre-funded.

(v) For supporting interest payments, both guarantees and direct financing can be used. Direct financing has the advantage of minimizing the Bank's entanglement with commercial creditors but by the same token, would reduce the level of support that is provided. Guarantees have the advantage of greater flexibility in their application, and allow for withdrawal of the Bank's support on such obligation over time.

(vi) Bank resources should be used for cash buybacks primarily to "clean out" commercial bank debt and only when the share of commercial debt in overall indebtedness is not large but the discounts on that debt are large.

(vii) In any event, debt reduction undertaken by the Bank must be carefully coordinated with similar efforts by the IMF, other organizations and creditor country governments.

Revised 3/29/89
Jonathan Hay (DFS)

STAFF WORKING PAPER
POSSIBLE ISSUES IN REGULATORY AND TAX POLICY AFFECTING DEBT RESTRUCTURING OPTIONS

1. Tax, regulatory, and accounting policies have frequently been cited as an area where actions by creditor governments could contribute to easing the debt problems of developing countries. Such policies are often mentioned as potential tools to increase the flexibility of commercial banks in debt negotiations. While net cash flow is the fundamental economic consideration for commercial banks in choosing debt restructuring options, banks are also influenced by the way in which tax, regulatory, and accounting policies govern the translation of cash flows into income, assets, and capital, and thus partially determine a particular transaction's profitability on an after-tax basis.

2. This technical note discusses some of the issues that arise in trying to identify changes in tax, regulatory, and accounting policy which could increase the flexibility of commercial banks in sovereign debt negotiations.1/ This brief note is divided into four sections. The first section discusses in very general terms the way in which tax and regulatory policy can create incentives for commercial banks to participate in different financing packages. The second section discusses the evolution of existing regulatory and tax policies with respect to LDC debt. The third section discusses the general options that exist for the further evolution of these policies. The fourth section summarizes the changes in tax and regulatory policy that are tentatively suggested in this note.

Section 1: General Issues

3. The regulatory and tax treatment of developing country debt can produce incentives for banks to participate in different kinds of financing facilities. Regulatory policy creates incentives for banks by determining the extent to which a bank's capital must be allocated to different financial instruments. Identical financing instruments may have different regulatory "values" in different regulatory regimes. For example, in some countries banks must allocate large amounts of capital, in the form of specific reserves, to their claims on highly indebted countries; in other countries these requirements do not exist.

4. All other things being equal, banks have an incentive to hold assets which require the least amount of regulatory capital. For example, regulatory policy encourages banks to renegotiate their claims on a troubled debtor country to the extent that the amount of regulatory capital that must be allocated to the renegotiated claims is less than that which must be

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1/ It is important to keep in mind that creditor country regulatory and tax policies are highly complex and that the issues can be dealt with in this brief note in only a very general way.

allocated when the country falls into arrears. The form that the renegotiated claims take will be influenced by the regulatory treatment of different types of assets. Regulatory polices in many countries have encouraged new money loans by requiring much smaller allocations of regulatory capital to new money loans than to arrears or, in some cases, interest capitalization. On the other hand, regulatory policies have discouraged voluntary debt reduction in some countries. Banks have had a strong disincentive to participate in debt reduction where upon accepting an asset with concessionary terms they must recognize a large upfront loss of regulatory capital.

5. Tax policy creates important incentives for banks by defining the extent to which losses recognized are shared with the public sector. Obviously, banks have an incentive to maximize the portion of loss born by the public sector. Tax policy can create incentives for banks to recognize losses by increasing the share of loss that will be absorbed by the public sector. The sharing of loss between the public and private sectors will be affected by marginal tax rates and the timing of loss recognition. Tax policy can also create incentives for banks to recognize losses in specific types of transactions by varying the extent to which the loss is shared with the public sector with the form in which the loss is taken. For example, creditor governments could encourage banks to participate in voluntary debt reduction by offering to adsorb a relatively greater portion of the loss where banks provide some debt forgiveness to the debtor country.

Section 2: Existing Regulatory and Tax Policies

6. In 1982 creditor governments responded to the debt crisis by taking coordinated actions to protect the international banking system. While creditor governments had a common objective, their tax and regulatory policies used to accomplish this objective took somewhat different forms.

7. In the United States, banking regulators took actions designed primarily to support the new money process as a way of buying time for the banking system to recover. For example, regulators did not require banks to allocate large amounts of regulatory capital to developing country loans through the creation of specific reserves against existing claims or new money contributions. At the same time, they used the 90-day rule and the ICERC process to hold out the threat that if financing packages were not negotiated banks would not be allowed to recognize income and would eventually be forced to write down assets.2/

2/ The Interagency Exposure Review Committee (ICERC) was empowered by the United States Congress in 1983 as part of The International Lending Supervision Act of 1983 to require specific provisions related to international loans when the quality of particular assets had been clearly "impaired" as evidenced by a "protracted inability" to pay (normally 180 days). The 90-day rule was clearly articulated in a June 1984 statement by the OCC and the Fed. It required that banks not accrue interest on a loan if interest remained "unpaid for 90 days or more unless the loan is both well secured and in the process of collection."

8. United States regulators also avoided taking action that would encourage banks to be imprudent in meeting country financing needs by assuring that banks continued to make positive decisions to lend rather than--for example--making use of interest capitalization.3/ Forcing banks to take a positive decision to grant new loans helped to put some limits on the process. Interest capitalization might have made the financing decision a relatively passive one and, therefore, one that would have been difficult to control.

9. With respect to the tax treatment of provisions, the United States did not allow the tax deductibility of "general" provisions established against LDC loans. This policy has helped preserve some tax incentive for commercial banks to realize losses. United States banks are allowed to deduct specific mandatory provisions from taxable income, but such provisions have only been required in a few countries, none of them a major debtor to commercial banks.

10. While United States banks continue to have an incentive to realize tax losses, they do not necessarily have an incentive to do so through voluntary debt reduction. This is because United States banks have alternative methods available to them for the realization of tax losses. They may realize such losses, for example, through sales in the secondary market and debt swaps. Loan charge-offs may provide an avenue for recognizing tax losses, although there is still substantial uncertainty surrounding the tax treatment of loan charge-offs in the case of sovereign loans. In the United States there are no laws, regulations or case law which precisely define the conditions that must obtain for a sovereign loan to be charged-off for tax purposes. Secondary market sales, debt swaps between creditors and loan charge-offs may provide banks opportunities for realizing tax losses without conveying any reduction in debt service to borrowers.

11. United States regulatory policy for the most part was directed towards supporting the new money process. Regulatory policy has discouraged interest capitalization and voluntary debt reduction. Interest capitalization is discouraged by regulatory policy which essentially requires a 100% specific reserve against capitalized interest. In contrast no specific allocations of regulatory capital have been required in the case of new money loans. Voluntary debt reduction is discouraged by the fact that banks in many cases are required to recognize an upfront capital loss upon participation in voluntary debt reduction. Since most United States bank provisions against LDC assets are general provisions (which are included in regulatory capital), provisioning has not decreased the capital loss that would have to recognized upon participation in voluntary debt reduction. However, United States regulations have left open the opportunity of extending regulatory relief to debt reduction techniques such as reduced rate loans. This could be done through the accounting treatment,

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3/ United States regulators have repeatedly indicated that "it would not be considered appropriate" under current policies to treat capitalized interest as income. See "Study on Accounting and Regulatory Policies Affecting Debt Restructuring", March, 1989 by OCC, the Federal Reserve and FDIC, p.15.

FASB 15, which would allow banks to delay the recognition of loss where banks have made a significant concession to the debtor.

12. In Germany, authorities encouraged banks to increase their capitalization by granting tax deductibility to specific provisions.4/ Given the relatively high tax rates in Germany (56% on undistributed profits), the tax deductibility of provisions provided a strong incentive for German banks to reserve against their LDC loans. One might have expected that the practice of allocating large amounts of regulatory capital to LDC assets in the form of specific provisions would have discouraged the new money process. As the amount of regulatory capital which needed to be allocated to new money loans increased the difference in the regulatory treatment of new money and arrears decreased. As time passed German banks were, therefore, likely to find fewer regulatory benefits in making new money loans. At the inception of the debt crisis, the risk that the crisis posed to the banking system was so severe that these provisions did little to discourage new money contributions. But, as the banking system recovered, these provisions have probably worked to discourage new money. In addition the use of specific provisions has meant that German banks confront a relatively weak distinction between new money and interest capitalization. This is in contrast to the situation in the United States where the regulatory treatment of interest capitalization is substantially worse than that of new money.

13. While German regulatory policy had the effect of removing some of the incentives for new money, German tax policy removed tax incentives for German banks to dispose of assets. The result has been that German banks are reluctant both to grant new money and to dispose of assets on the secondary market or through debt reduction operations. German tax and regulatory policy has arguably put German banks in a position where they can afford to be relatively indifferent to the financing needs of the highly indebted countries.

14. Initially France and the United Kingdom followed policies similar to those implemented in the United States. But as banks in the United Kingdom began to improve their position, banking regulators began to move towards a system of specific reserving against LDC assets. This move culminated in 1987 with the issuance of the Bank of England (BOE) matrix for establishing specific provisions against LDC claims. The BOE excluded these provisions from regulatory capital. Inland Revenue quickly indicated that they would accept the matrix as a "basis" for determining the tax deductibility of provisions.5/ The United Kingdom policies initially had the

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4/ In a March 7, 1983 letter the Federal Ministry of Finance confirmed that specific provisions which "reflect the principles of cautiousness and the going concern principle" should be accepted for tax purposes. In a July 29, 1985 letter, the Federal Ministry of Finance confirmed that the Tax Authorities accepted the September 16, 1983 judgement of the Hessian Fiscal Court according the tax deductibility of provisions at the 50% level against loans to Poland.

5/ It should be noted, however, that Inland Revenue's position (unlike in France, for example) on this issue has no legal status. The criteria impact of fully supporting the new money process. By allowing the tax deductiblity of provisioning, the matrix has served to put some break on this process while removing some of the incentives to replace the process through debt reduction6/

15. In France, banking authorities began requiring specific provisions in 1984.7/ The provisions have been treated as tax deductible.8/ Due to the weaker capitalization of the larger French banks, banking authorities allowed these specific provisions to be included in regulatory capital. In addition, banking authorities in France pushed for some key provisions in the Basle Agreement which would allow for more significant inclusion of loan loss reserves in capital in future years. The end result is that provisioning has been attractive for French banks, since it allows them to make a tax free addition to their capital.9/ This strategy has been an effective way of strengthening the French banking system, but it has also made debt reduction relatively unattractive for French banks since debt reduction would involve a capital cost (provisions are included in regulatory capital) and tax deductions have already been realized through provisioning. But it has also given French banks little of the regulatory incentives that United States banks have for participating in new money exercises, since the cost of arrears for French banks is lessened by the regulatory treatment of provisions. For United States banks, the cost of arrears is much greater due to the sharp difference between current and non-performing assets in the United States regulatory system.

16. In Japan, Ministry of Finance policy has been to encourage the new money process. In some sense, the Japanese policy has been the most tightly

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for determining tax losses in the sovereign context must be tested in U.K. tax courts. As in the United States, this process has yet to take place.

6/ The reserves required according to the U.K. matrix are somewhat low by international standards. Consequently the BOE matrix and accompanying tax policy have had much less of an impact on banks in the United Kingdom than the German tax and regulatory policy has had on German banks.

7/ On June 30, 1984, the Commission Bancaire issued a "recommendation" outlining the standards for provisioning.

8/ The Director of the Tresor issued a private letter in March of 1987 which indicated that country risk provisions would be tax deductible. French banks, however, had taken the position that the reserves were tax deductible according to French tax law.

9/ The Basle guidelines will limit this to some extent, but French banking authorities have indicated their intention to take advantage of the provision in the Basle guidelines which allows for loan loss reserves to be included in regulatory capital up to 2.25% of risk-weighted assets--instead of 1.25%, which would normally apply after year-end 1992.

controlled of any of the creditor governments. No significant specific provisions have been required,10/ banks have not been allowed to dispose of assets,11/ and the tax deductibility of losses on LDC loans has been virtually impossible.12/ Due to the very stringent tax policy implemented in Japan with respect to LDC debt, Japanese banks may be influenced in the future by the evolution of MOF rules on the deductibility of losses on sovereign debt from taxable income. If tax deductibility is granted through provisioning, Japanese banks are likely to hold onto existing assets to a larger extent. On the other hand, if tax deductibility is granted only in the context of loan sales, Japanese banks are likely to move more quickly to dispose of those assets.

Section 3: Options for Further Evolution of Tax and Regulatory Policies

17. In evaluating what tax and regulatory policy changes might make sense, it is important to establish what the objectives of such policy changes would be. With respect to the LDC debt situation there are basically two choices: i) to change policies to encourage banks to provide financing by increasing the claims on debtors either through new money loans or interest capitalization; or ii) to change policies to encourage debt reduction. We consider these choices below.

Policies Designed to Encourage Banks to Increase Their Claims

18. It is unlikely that tax and regulatory changes designed to rejuvenate the new money process would be possible, for at least two reasons. First, the problem of free-riders makes the new money process very difficult to negotiate. This problem may be very difficult to address through tax and regulatory changes. While it has sometimes been suggested that tax and regulatory authorities specifically penalize those banks which do not wish to participate in financing packages, it is difficult to see how such policies could be justified with respect to general tax and regulatory principles. It might be equally different to enforce tax and regulatory policies designed to discourage free-riding.

19. Second, regulatory changes designed to rejuvenate the new money process would have to fight current trends towards more prudent and accurate financial and regulatory reporting. Such changes might include eliminating requirements for specific provisions against new LDC exposure. It is difficult to believe that regulatory changes of this type would be likely to

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10/ In 1983 Japanese banks were allowed establish a special reserve against a basket of LDC loans equal to only 5% of problem exposure. This in 1987 this was increased to 10% and in January of 1989 to 15%, still far below reserves in any other country.

11/ Japanese banks must get MOF approval to sell loans. MOF has allowed limited loans sales to JBA Investment, a Cayman-based financial company established by Japanese commercial banks. They can currently sell only 4% of eligible loans which included rescheduled debt and new money.

12/ Japanese banks are allowed to deduct reserves from taxable income equal to only 1% of problem LDC assets.

occur. Regulatory changes which increased or protected the "regulatory value" of new money loans might be difficult to reconcile with an emphasis on prudent financial and regulatory reporting, unless the new money had some special characteristics which increased its "regulatory" security.

20. While it may be difficult to rejuvenate the new money process, it might be possible to replace new money with interest capitalization. Interest capitalization has frequently been suggested as a means of facilitating negotiations between debtors and creditors. One of its advantages is that it could help ensure burden sharing among creditor banks. One of the main obstacles to interest capitalization results from its regulatory treatment in United States. United States regulators have indicated that it "normally would not be considered appropriate" under current policies to treat capitalized interest as income. 13/ While new loans, on the other hand, could be considered a near equivalent to interest capitalization under some circumstances, United States banks can count interest payments linked to new money loans towards income and maintain both existing loans and the new loans on their books as performing assets. United States banks consequently have a strong regulatory incentive to choose new money over interest capitalization. Making new money loans allows them to report higher earnings and higher regulatory capital14/ than otherwise would be possible. United States banks are also uncomfortable in allowing other banks to capitalize interest since this may jeopardize the advantageous accounting for new money by increasing the perception that new money is in fact interest recycling.

21. A modest regulatory change which could facilitate debt negotiations would be for United States regulators to state unambigously that where interest capitalization is offered as an alternative to new money, the regulatory treatment of new money will not be affected.

22. The regulatory treatment of interest capitalization in other countries is similar to that of new money loans. In these countries, capitalized interest could be treated as current income. As with new money, loan loss reserves would be created by partial charges to income to the extent that banks believe that the ultimate collectibility of the capitalized interest is in doubt. Where this is the case, banks are encouraged to focus on the more fundamental role that interest capitalization might play in a financing packages rather than the difference in regulatory treatment of interest capitalization and new money.

23. Consequently, one approach to increasing the flexibility of banks in the process of debt renegotiation would be to take regulatory actions which would have the effect of "equalizing" the treatment of interest capitalization and new money for regulatory and accounting purposes. Removing differences in the regulatory treatment of these two options may encourage banks to focus on the fundamental advantages and disadvantages of

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13/ OCC, Federal Reserves and FDIC, March 1989. p.15.

14/ Higher regulatory capital would not result if banks paid out the increased earnings to shareholders.

interest capitalization as a means of meeting country financing requirements.

24. There are basically two ways to equalize the treatment of interest capitalization and new money. One way would be to "upgrade" the regulatory treatment of interest capitalization, making it similar to the current regulatory treatment of new money in the United States. The other option would be to "down grade" the regulatory treatment of new money, making it similar to the current treatment of interest capitalization in the United States. The former approach is unlikely since it contradicts the trend towards greater prudence in regulatory and accounting practices. The latter approach may be a more acceptable scenario for encouraging the use of interest capitalization. (This approach would be relatively more costly for United States banks.)

25. Consequently, if the objective is to encourage banks to negotiate additional financing for debtors without debt reduction, it might make sense to remove the ability of banks to recognize income (or some portion of income) on new money loans under certain conditions. For example, regulators might limit the ability of banks to recognize income to those cases in which the payment of interest is reasonably certain. This would be to apply a standard to new money that is similar to the standard currently applied to interest in the United States. This should be done carefully in order to maintain some distinction between arrears and interest capitalization. One way to do this would be to force write downs when countries are in a protracted state of arrears but to maintain the assets on which interest is being capitalized at full face value and to allow payments to be counted towards income as they are received.15/

Policies Designed to Encourage Banks to Decrease Their Claims

26. The second objective that changing regulatory and tax policy might have would be to encourage voluntary debt reduction. The important regulatory issue is what amount regulatory capital needs to be allocated to existing assets compared to the amount which needs to be allocated in the case of voluntary debt reduction. Regulatory incentives for voluntary debt reduction can be created by shifting regulatory policy towards a more lenient treatment of reduced claims and/or towards a harsher treatment of existing assets.

27. The important tax issue concerns the portion of loss that the public sector shares where a bank participates in voluntary debt reduction compared to the situation in which it does not participate. Modest tax incentives could be created by allowing banks that participate in voluntary debt reduction to recognize tax losses without recognizing book losses. Greater tax incentives could be created for voluntary debt reduction can be created by establishing tax policies which ensured that the public sector will bear a larger portion of the loss where the bank participate in voluntary debt reduction. This could be done by increasing the tax rate

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15/ Any payments received in the state of arrears would have to be applied towards principal and could not be counted as income.

applicable to voluntary debt reduction and/or by decreasing the tax rate applicable to transactions in which tax losses are realized.

28. The regulatory and tax treatment of loan loss reserves is very important in creating incentives or disincentives for voluntary debt reduction. With respect to the regulatory treatment of loan loss reserves, the relevant question is whether or not loan loss reserves are included in regulatory capital. In some countries, loan loss reserves against sovereign risk are included in capital while in others they are excluded. Where established loan loss reserves have been excluded from capital, regulators have in effect required banks to recognize a reduction in leverageable capital through reserving. For banks that are constrained by their lack of regulatory capital, this may be a painful process. On the other hand, where loan loss reserves are included in regulatory capital, no such recognition of capital loss for regulatory purposes has been required. The regulatory treatment of reserves can create differences in the "regulatory value" of assets.

29. The recently adopted Basle guidelines will eliminate, over time, many of the differences that exist in the regulatory treatment of loan loss reserves. The Basle Agreement excludes loan loss reserves in excess of 1.25% of assets after year-end 1992. This means that additions to loan loss reserves (for banks that already have high reserve levels) will increasingly be perceived as a capital loss. To the extent that the treatment of loan loss reserves in the Basle guidelines forces banks to allocate greater amounts of regulatory capital to their LDC assets, the new guidelines may remove some of the disincentives to voluntary debt reduction that currently exist. For the next two years, however, important differences in the regulatory treatment of reserves exist and create correspondingly different incentives for banks.

30. Where reserves are <u>included</u> in regulatory capital (as in France, the United States and Japan) banks are unlikely to want to take losses and write down reserves. In these cases, an important distinction is likely to arise between the "regulatory value" of existing assets and that of any new assets accepted in exchange for existing assets. For example, it may be the case that an <u>enhanced</u> exit bond paying a fixed rate of interest of 5% that is exempt from new money calls has an equal market value to an existing asset which is neither exempted from new money nor enhanced in any fashion.16/ While the <u>economic</u> value of these two assets may be the same, there may be important differences in their "regulatory values." Where loan loss reserves are included in capital, the "regulatory value" of the existing asset may be higher than that of the exit bond, which if accepted may need to be written down to its "fair" value. So long as a distinction is maintained between the "regulatory value" of holding on to an existing asset at face value (with "reserves") and the "revised value" of a new reduced rate asset, banks are likely to have an incentive to retain their existing asset. Excluding reserves from regulatory capital--which will happen to

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16/ The exit bond might be enhanced, for example, by being convertible into a local currency instrument carrying a fixed rate of interest, equity investments or by a guarantee of principal or interest.

some extent as the Basle guidelines are implemented--will thus alter the incentives for banks to participate in such transactions.

31. Where loan loss reserves are already excluded from capital (as in Germany, the U.K., Switzerland and Canada) banks recognize no further capital loss when assets are written off against reserves. In such circumstances, regulatory policy may be relatively neutral with respect to the incentives it creates for banks to participate in voluntary debt reduction.17/

32. The tax treatment of loan loss reserves may also create important incentives for banks to dispose of their assets. Where a bank must dispose of an asset before it can realize a tax loss, banks will obviously have a stronger incentive to dispose of their assets. Obviously, here the tax rules relating to debt swaps and loan charge-offs will also be very important, since these operations may offer banks alternative methods of capturing tax deductions. Where banks are able to realize tax losses through provisioning or other means that do not involve disposing of their assets (e.g. charge-offs), banks will have no such tax incentive.

33. The treatment of loan loss reserves for tax purposes is a central issue in this discussion. The tax deductibility of loan loss reserves would seem to remove an important incentive for disposing of assets (or for participating in voluntary debt reduction). Allowing tax deductions for debt swaps (between creditors) has a similar impact.

34. The table below summarizes the regulatory treatment of loan loss reserves against sovereign risk in the main creditor countries:

LOAN LOSS RESERVES

Country	Average level of Reserves *	Included in Capital	Tax Deductible
Canada	40%	No	Yes
France	45%	Yes	Yes
Germany	55%	No	Yes
Japan	10%	Yes	Only 1% of LDC Assets
U.K.	35%	No	Up to matrix levels
U.S. Money Center	30%	Yes	No
U.S. Regional	50%	Yes	No

35. The tax and regulatory treatment of reduced rates loan may also influence the willingness of banks to participate in debt reduction. In some countries, reduced rate loans may be left on bank books at their face value. In the United States, for example, the accounting treatment described in Financial Accounting Standard Board (FASB) Number 15 allows for

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17/ To the extent that reserves must be replenished after a write-down (and reserves are excluded from capital) there will be a capital cost to a write-down, but the capital cost will still be less where reserves are excluded from capital than where they are not.

a delay in the recognition of loss under some circumstances. Apparently the exit bond issued as part of the 1988 Brazilian refinancing program qualified for FASB 15 treatment.18/ However, where banks leave the reduced rate loan on their books at face value they would, in most cases, be forced to recognize their loss for tax purposes as the same rate that they recognize their loss for book purposes. One possible change in regulatory and tax policy would be to allow banks to recognize the tax loss upfront, eventhough the recognize the loss for regulatory and book purposes over a number of years.

36. FASB 15-type regulatory treatment boils down to offering banks a form of regulatory relief "in return" for renegotiating their claims with debtors at concessionary rates. The extent to which this represents an incentive for banks to reduce their claims will depend in part upon the regulatory treatment of arrears. If when a country is in arrears banks must write down their claims, a bank may have an incentive to accept the reduced rate loan. Such accounting and regulatory treatment may be one way of removing distinctions between the regulatory value of existing assets and new assets with concessionary terms.

Section 4: Some Potential Policy Suggestions

37. Given the above incentives created by the regulatory and tax treatment of loan loss reserves and reduced rate loans, it may be worth considering three types of policy changes which may provide incentives for banks to participate in voluntary debt reduction.

38. First, regulatory actions could be taken to clearly differentiate arrears on the one hand from negotiated debt reduction resulting in realistic financing packages which, through temporary or permanent debt relief, pave the way for a more lasting settlement of commercial bank claims. This could be done by decreasing the "regulatory value" of claims which are not being serviced and treating more leniently the valuation of claims which are being serviced even if the form of those claims involves significant negotiated concessions from creditor banks. This could be accomplished through a quicker write down of assets once a state of arrears has occurred combined with a clearer and more favorable regulatory treatment of renegotiated assets. Current accounting and regulatory treatment of reduced rate loans in some creditor countries might be extended, clarified, and/or improved to carry out this task. Such a regulatory policy might also be tied to the use of official credit enhancement. Official credit enhancement might provide a suitable justification for giving more favorable treatment to the reduced rate asset.

Second, a relatively most change in tax policy would allow banks, as mentioned above, to tax deductions upfront eventhough they are recognizing losses for regulatory and accounting purposes over a number of years.

39. Third, tax policy could be clearly defined to limit the ability of commercial banks to take tax deductions for "unrealized losses." Tax

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18/ OCC, Federal Reserve and FDIC, March 1989. p. 13.

authorities could provide incentives for banks to participate in voluntary debt reduction by limiting the ability of banks to recognize tax losses through reserving and swapping. Such a policy might be justified by pointing to the uncertainty which surrounds the actual size of losses on LDC debt and the unreliability of so-called secondary market "prices."

40. Naturally, it is important in exploring such changes to bear in mind the need to design tax and regulatory changes that provide incentives for voluntary debt reduction and that are also consistent with general tax and regulatory principles. Tax and regulatory policy are established to deal with many different concerns--the LDC situation is only one of these. LDC assets represent a relatively small portion of creditor country financial assets. Creditor governments may have very understandable reasons for being reluctant to alter long standing policies for the sake of the LDC situation, where they feel that such alterations would be likely to have consequences far beyond the LDC debt situation.

41. In this regard, it is important to separate two questions. The first question concerns the rationale or justification for such changes. The second type of question concerns the level of policy making that is required to make the kinds of changes in regulatory and tax policy that have been suggested. Obviously, policy actions which require legislative approval are of a different nature than those which require only the interpretation of existing legislation by government agencies.

SUMMARY OF SUGGESTIONS FOR REGULATORY AND TAX POLICY

OBJECTIVE	METHOD	SPECIFIC POLICY
I. Encourage Banks to Increase Claims on Debtor Countries	1. Clarify treatment where interest capitalization and new money are combined a single financing package	In United States issue regulatory guidance which states, unambiguously, that the regulatory treatment of new money loans will not change where some banks are allowed to choose interest capitalization as an alternative to new money
	2. Equalize treatment of new money and interest capitalization.	
	a) "Downgrade" regulatory treatment of new money.	Require U.S. Banks to Reserve 100% against new money loans.
	b) "Upgrade" regulatory treatment of interest capitalization	Allow U.S. banks to recognize capitalized interest as income.
	3. Make treatment of arrears much worse than treatment of both existing and new claims where a negotiated increase in claims takes place.	Mandate a quicker writedown of assets when country is in arrears. Negotiate tax deductions on a case-by-case basis, and only allow tax deductions where loss is certain.

OBJECTIVE	METHOD	SPECIFIC POLICY
Encourage Banks to Participate in Voluntary Debt Reduction.	1. Make both regulatory and tax treatment of arrears worse than treatment of voluntary debt reduction.	
	a) Make regulatory and tax treatment of arrears worse	As above, mandate quicker writedown of assets when country is in arrears. Negotiate tax deductions on a case-by-case basis and only allow tax deductions where loss is certain.
	b) Improve regulatory and tax treatment of voluntary debt reduction	Allow banks to participate in voluntary debt reduction without recognizing a capital loss. But allow banks a full upfront tax deduction equal to the difference between the tax basis of the old asset and the fair market value of the new asset.
		--and/or only allow banks a tax deduction to the extent that they participate in voluntary debt reduction.
		Allow banks to exchange assets in voluntary debt reduction operations without "contaminating" any part of their portfolio.
	2. Give a more favorable regulatory treatment to assets which involve the official sector	-- treat guarantees and and collateral at face value for assets which involve purposes of calculating BIS capital guidelines and reserve requirements.
		-- give favorable treatment to linkages with lending programs of multilateral institutions.
		-- give more favorable treatment where debt reduction operation is part of a World Bank/IMF adjustment program.

Draft Operational Guidelines
World Bank Financial Support for Debt Reduction

1. The Bank will provide financial support for debt reduction transactions provided that the borrower has:

(a) committed to, and is in the process of implementing, a comprehensive medium-term adjustment program acceptable to the Bank;

(b) developed a viable, medium-term external financing plan that includes realistic objectives and approaches to debt reduction.

2. The amount of financial support that the Bank will provide will be determined on a case by case basis, up to approximately 40% of total adjustment financing operations [i.e., 25% of presently planned commitments plus a matching amount from the "pool" of $6 billion in additional commitments].

3. Commitments will be tranched over 2-3 year periods, subject to trance release conditions typical of Bank adjustment lending. Drawdowns may be front-loaded up to [50%] over the first 12 months.

4. Within the overall commitment limit for a specific debt reduction program, Bank resources may be drawn down for any of the following purposes, subject to the general conditions set out below and Bank management review of the terms of specific transactions:

(a) Loans to finance buyback operations. The Bank will finance up to 50% of specific buyback operations that are expected to result in, or are clearly linked to, comprehensive resolution of a country's debt servicing problems. The Bank will need to be satisfied as to the objectives and procedures to be followed in the buyback, including inter alia (i) adequate safeguards against "free riding" , (ii) evidence that the bidding/tendering process is professionally designed and fully competitive, and (iii) likelihoo that average tender prices will be reasonably close to prevailing secondary market levels. In no event will the Bank finance a buyback operation where the [average] [maximum] price paid exceeds [two-thirds] of face value.

The terms and conditions of such loans will be those normally applie to the country concerned, including standard currencies of disbursement an repayment. Although not a condition of such loans, it is expected that lending by the Bank to finance buyback operations will be in parallel with

IMF loans for the same purposes. Cofinancing from other sources equal to a least 50% of the transaction value will be required in any event.

[Note: these conditions will exclude direct use of Bank resources for buyback programs that operate continuously and are designed to absorb debt out of the secondary market over a period of time. Borrowers will be free to negotiate and operate such programs (provided they can secure the necessary waivers), funded out of general revenues or reserves, a portion of which would obviously be traceable to Bank lending for adjustment purposes. The effect of these conditions is to limit direct Bank support for buybacks to the smaller countries where comprehensive settlements may be possible and where multilateral support is available.]

(b) Loans to finance collateral for debt exchange transactions. The Bank will finance the purchase of collateral to cover (i) defeasance of principal in debt exchange transactions and/or (ii) a portion of interest payments. Borrowers will be encouraged to secure cofinancing from other sources, including in particular the IMF. In no event will the Bank finance more than [25]% of the present value of the instrument being secured (calculated according to a methodology acceptable to the Bank).

Loans for the purpose of providing support to interest payments may be in the form of either: (i) full and immediate disbursement into trust or escrow accounts; or (ii) revolving lines of credit, including syndicated lines of credit involving other lenders. The maximum terms for such loans and credit lines will be those normally applied to the country concerned [and may be shorter depending on the specific transaction]; to the extent possible the Bank will make currencies available to the borrower appropriate to its escrow obligations [and will assist borrowers in managing exchange risks associated with significant mismatches between escrow/trust fund assets and repayment obligations to the IBRD].

The terms and conditions of specific debt exchange transactions will be subject to World Bank review. The Bank will need to be satisfied that exchange prices are competitively determined and reflect current secondary market conditions. The Bank will not provide financing for transactions for which the [present value reduction] [discount] is less than [one-third] of face value. [This condition needs to be reviewed carefully and expressed more precisely.]

(c) Guarantees on interest payments on debt exchange transactions. The Bank will provide selective, limited guarantees to cover interest payments on debt exchanges where: (i) the instrument to which the guarantee applies is not part of a general debt restructuring agreement, is specifically exempted by the borrower from restructuring and "new money calls", and has other enhancements/characteristics that distinguish it from existing commercial bank restructuring agreements and syndicated credits; or (ii) the guarantee facilitates a comprehensive restructuring of a country's external debt service obligations and resolution of its debt service problems.

Guarantees will be provided only for minimum interest rates, normally well below current market levels and determined on a case by case basis but in any event not to exceed [6]% p.a. The Bank will guarantee up to three years' payments at the minimum rate, on a rolling basis, but arrears on the unguaranteed portion of interest due may not be used to trigger a ca on the guarantee.

The term of the guarantee will initially be for [5] years, but may be extended up to a total of [10] years at the World Bank's option. Once called, rolling guarantees will be reinstated only at the option of the Bank and only if the events triggering the guarantee are satisfactorily remedied by the borrower. In no event will such guarantees account for more than 20% of the present value of the instrument involved (calculated in a manner satisfactory to the Bank).

The Bank will not agree to subordinate its claim on the borrower under its counter-guarantee agreement, nor will the Bank accept restrictions on its rights to settle its claim with the borrower in a manner acceptable to the Bank.

The Bank will charge a flat fee of %.