IBRD Interest Rate Risk Management Solutions

**Highlights**

- Converting floating interest rate debt to fixed rate debt reduces uncertainty in borrower’s debt management strategy.
- IBRD can convert disbursed and outstanding balances of floating interest rate of IBRD loans into fixed interest rate loans.
- IBRD can also fix the interest rate on non-IBRD loans through the use interest rate swaps.
- IBRD offers advisory services to assess and manage interest rate risk in line with the country’s debt management strategy.

Borrowing at a floating interest rate exposes sovereigns and sub-sovereigns to interest rate risk, which can lead to higher debt servicing costs in a rising interest rate environment. As the reference rate changes over time, borrowers who pay floating interest rates will see their interest payments fluctuate depending on market conditions (see Annex 1 for the market environment). This movement of interest rates can result in greater uncertainty in a borrower’s debt management strategy. Rising interest rates can negatively affect economic performance, put pressure on a country’s budget, and result in either spending cuts or higher deficits.

**Managing interest rate risk for sovereigns and sub-sovereigns**

Sovereigns and sub-sovereigns (such as state-owned enterprises or local governments) can mitigate their interest rate risk by reducing the exposure of their floating debt portfolio, either by issuing new fixed-rate debt or by modifying the characteristics of outstanding floating rate debt. The decision to fix the interest rate should be based on a cost-risk analysis as part of a government’s robust debt management strategy. Such considerations would also include factors such as currency, tenor, repayment schedule, contractual obligations, and others.

**IBRD interest rate risk management solutions**

IBRD offers two important financial solutions for borrowers to manage interest rate risks, including:

**Interest Rate Conversions:** The IBRD Flexible Loan (IFL) is based on a floating reference rate, which varies by currency (SOFR for USD, TONA for JPY, SONIA for GBP and EURIBOR for EUR) plus a spread that is variable on a quarterly basis. Borrowers can fix the floating reference rate of all or part of the disbursed and outstanding balance of an IBRD loan, using conversions that are embedded in the IBRD loan agreement. At the time of IBRD loan negotiation, borrowers can establish a schedule for the floating reference rate fixings automatically (e.g., at each interest payment date, annually, or at some other frequency); or request conversions on an ad hoc basis at any time during the life of the loan. They can also unfix or refix the reference rate on disbursed amounts at any time during the life of the loan by submitting a request for conversion to IBRD. No additional agreements are required.

**Interest Rate Caps and Collars:** Borrowers can also use interest rate caps and collars for protection against rising and volatile interest rates. Interest rate caps are individually negotiated transactions that set an upper limit on the interest an IBRD borrower would pay on a floating rate loan. As this upper limit represents an option that the borrower purchased from IBRD (by paying an upfront premium), borrower maintains open the possibility of benefiting from low-interest rates while staying protected against adverse increase in rates. In addition to the premium cost of an interest rate cap, borrower also pays a transaction fee to IBRD. Interest rate collars are individually negotiated transactions that set an upper and a lower limit on the interest a borrower would pay on a floating rate loan. Borrowers can choose this option by requesting to set interest rate caps or collars, available on the World Bank Treasury website. Transaction fees apply (see Annex 2 for details).
**Interest rate management for non-IBRD loans**

IBRD risk management solutions also allow the borrower to fix the interest rate risk on liabilities to third parties (outstanding bonds or loans with other lenders) through the use of interest rate swaps. Borrowers who wish to use swaps enter into an International Swaps and Derivatives Association (ISDA) Master Agreement with IBRD. Transaction fees apply (see Annex 2 for details). The borrower may at any time submit a request for a swap transaction to fix the interest rate of the principal amount (withdrawn and outstanding) of a loan by submitting a request form for an interest rate swap for a non-IBRD hedge available on the World Bank Treasury website.

**Advantages of working with IBRD to fix interest rates**

- IBRD has a Triple-A credit rating, which reduces the country's exposure to counterparty risk.
- Commercial counterparties typically require the country to post collateral or charge additional fees when a country is unable to post collateral. IBRD does not require borrowers to post collateral or charge additional fees in place of collateral.
- Commercial counterparties charge clients for credit risk. IBRD does not charge borrowers for credit risk and provides the same competitive pricing to all borrowers.
- Loan conversions are administratively simple for borrowers. Conversion provisions are embedded in the IBRD loan. No additional documentation is required. Commercial counterparties require countries to sign ISDA, which is expensive, time-consuming, and complex.
- IBRD can provide technical assistance and capacity building in derivative pricing and execution.
- The World Bank Treasury can provide indicative fixed rates for specific loans and execute transactions.

**Additional information**

Please contact your World Bank Treasury Banker or Miguel Navarro-Martin, Manager, Financial Products and Client Solutions, via email (mnavarromartin@worldbank.org) or telephone (+1-202-458-4722).

Annex 1 – Market environment

The year of 2021 is ending with persistent high inflation rates in the United States (specially CPI and PPI) due to dovish fiscal and monetary policies enacted to minimize the negative impact of COVID-19 on the economy. As demand increase substantially during the last 18 months, supply (labor, raw material, and agricultural goods) failed to grow at the same speed compounded by disruptions in the global supply chain. In fact, during a testimony to congress on week of December 1\textsuperscript{st}, FED Chair Powell admitted that inflation is no longer transitory. Consequently, it is prudent for the FED to continue to taper bond purchase as market expected. At the same time, market anticipates higher fed fund rates in 2022, with a consensus of at least three rate hikes. In fact, the USD interest rate yield curve below signals the possibility of materially higher rates towards in 2022, specially during second half of the year.

It is important to recognize that, depending on the evolution of COVID-19 variants (such as Omicron), such a scenario of higher rates may not fully materialize in 2022. The FED and other monetary authorities around the globe continue to monitor closely the pandemic situation in order avoid policy mistakes in one direction or another.

In such a scenario, markets are also anticipation increasing interest rate volatility in 2022. For that purpose, prudent interest rate risk management may prove to be an efficient way to minimize the impact of such volatility on a country's stock of international debt. The graph below shows a recent spike in the 30-day volatility of the USD 10-year swap rates.
$Libor3m vs Fixed

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>5 years</td>
<td>1.37%</td>
<td>s.a.</td>
<td>30/360</td>
</tr>
<tr>
<td>7 years</td>
<td>1.48%</td>
<td>s.a.</td>
<td>30/360</td>
</tr>
<tr>
<td>10 years</td>
<td>1.56%</td>
<td>s.a.</td>
<td>30/360</td>
</tr>
<tr>
<td>15 years</td>
<td>1.66%</td>
<td>s.a.</td>
<td>30/360</td>
</tr>
<tr>
<td>20 years</td>
<td>1.69%</td>
<td>s.a.</td>
<td>30/360</td>
</tr>
<tr>
<td>30 years</td>
<td>1.65%</td>
<td>s.a.</td>
<td>30/360</td>
</tr>
</tbody>
</table>

Source: Bloomberg (07 Dec 2021)

These levels, although higher than the levels at the end of 2020, are still historically low – especially considering the current high inflation environment.
Note: Market consensus levels of reference rate projections are based on the market's forecast of forward rates and may not be an accurate predictor of future interest rates. The World Bank does not project reference rates.

Contact: Miguel Navarro-Martin, Manager, Financial Products & Client Solutions, The World Bank Treasury
mnavarromartin@worldbank.org +1 (202) 458 4722 1225 Connecticut Avenue NW, Washington, D.C., 20433, U.S.A.
Annex 2 – Transaction fees

Interest rates have been relatively low and stable since the crisis in 2008. However, rates have been higher and more volatile in the past. For example, the 30-day volatility of the USD 10-year interest rate swap moved from around 17 percent at the end of 2007 to as high as 79 percent at the peak of the 2008 crisis. Since then, it has stayed within a range of 25 to 55 percent. When the market realized the extent of the potential impact of COVID-19 pandemic on the global economy, this measure of interest rate volatility reached a peak of 235 percent in April 2020.

Since then, interest rate volatility (as measured by the 30-day volatility of USD 10-year interest rate swap) has dropped, currently hovering around 60 percent. Still, these levels are quite elevated compared to the more normal levels of about 20-30 percent, indicating the market’s expectations for continuing changes in the level of interest rates over the next 12-24 months.

### Transaction fees for IBRD interest rate conversions

<table>
<thead>
<tr>
<th>Currency of the loan prior to the conversion</th>
<th>USD</th>
<th>EUR, GBP, JPY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rate fixings of disbursed amounts</td>
<td>0.050%</td>
<td>0.100%</td>
</tr>
<tr>
<td>Early termination of any conversion</td>
<td>0.02%</td>
<td></td>
</tr>
</tbody>
</table>

Note: For loans for which the reference rate + spread is lower than zero during the current interest rate period, transaction fees will be calculated on a case-by-case basis.

(1) Expressed as a percentage per annum on the outstanding loan amount unless otherwise indicated.

(2) Fees expressed as a percentage per annum will be converted to a lump sum.

### Transaction fees for interest rate swaps on liabilities to others

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Major Currencies</td>
<td>Local Currencies</td>
</tr>
<tr>
<td>Transaction fees for interest rate swaps on liabilities to others</td>
<td>0.03%</td>
</tr>
<tr>
<td>Transaction fees for Interest rate caps and collars</td>
<td>0.125%</td>
</tr>
</tbody>
</table>

(1) Note that the client must have an International Swaps and Derivatives Association (ISDA) master agreement with IBRD to execute these non-IBRD hedges. See: https://www.isda.org/ and contact the World Bank Treasury for more information.

(2) An additional fee for convertibility risk may apply for local currency swaps. The amount of this fee will be determined on a country-by-country basis.

(3) Expressed as a percentage of the principal amount involved, and payable as a lump sum.

Contact: Miguel Navarro-Martin, Manager, Financial Products & Client Solutions, The World Bank Treasury
mnavarromartin@worldbank.org +1 (202) 458 4722 1225 Connecticut Avenue NW, Washington, D.C., 20433, U.S.A.