FOR AGENDA

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November 30, 1993

To: Members of the Executive Board

From: The Acting Secretary

Subject: Modalities of Fund Support for Debt and Debt-Service Reduction

Attached for consideration by the Executive Directors is a paper on the modalities of Fund support for debt and debt-service reduction, which will be brought to the agenda for discussion on a date to be announced. A draft decision appears on page 7.

Mr. Rennhack (ext. 37350) or Mr. Hagan (ext. 37715) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Modalities of Fund Support for Debt and Debt-Service Reduction

Prepared by the Policy Development and Review and Legal Departments

(In consultation with other departments)

Approved by Jack Boorman and François Gianviti

November 29, 1993

Contents

I. Introduction

In the context of the annual discussion of the debt situation on September 3, 1993, the Executive Board discussed the segmentation of Fund resources used in support of debt and debt-service reduction operations with commercial banks. 1/ The majority of Executive Directors favored the elimination of segmentation restrictions, reflecting a desire to facilitate the process of debt restructuring for those countries still to negotiate bank packages that faced particularly difficult external situations. The Chairman accordingly suggested to return to the matter after the Annual Meetings to agree on a modification of the guidelines to remove the existing requirement of segmentation while taking carefully into account the views of those Directors who emphasized the need for balance in debt operations.

The present paper follows up on this discussion, within an approach aimed at ensuring that the new flexibility arising from the removal of the segmentation restrictions will be applied in a manner that would take into account the concerns expressed by some Executive Directors. It also proposes consequential modifications to the decision on early repurchase expectations with respect to debt and debt-service operations (Decision No. 9331-(89/167).

II. Background

As laid out in the current guidelines for the Fund's involvement in the debt strategy, set-aside resources can be used only to support operations involving principal reduction, such as cash buybacks and discount exchanges, while additional resources provided through augmentation can be used only for interest support for debt and debt-service reduction and for collateralization of principal in reduced-interest par bond exchanges. 2/

As discussed in more detail in the recent Executive Board paper on the debt situation (EBS/93/131), segmentation provisions have complicated the completion of bank packages in at least two cases (Argentina and the Philippines). Moreover, segmentation could impede future operations as countries that still have to restructure their bank debt look for innovative ways to resolve their debt situations. While there is no immediate proposal for Fund support of a debt package before the Board, negotiations are now underway for a number of countries in this category. One particular

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1/ See Summing-up by the Chairman, Financing for Developing Countries and their Debt Situation, Executive Board Meeting 93/124, September 3, 1993 (Buff 93/53) and the accompanying staff paper (EBS/93/131, August 12, 1993).

2/ See the guidelines set forth in Summing-Up by the Chairman, Fund Involvement in the Debt Strategy, Executive Board Meeting 89/61 (May 25, 1989) as modified at EBM/92/68 (May 29, 1992).

situation that could raise problems for Fund involvement under the current guidelines would be a country with a very limited medium-term debt-servicing capacity that seeks to maximize the extent of debt reduction through use of buybacks and discount exchanges (e.g., the menu structure in the term sheet negotiated by the Dominican Republic and also agreed in principle with Bulgaria). For such a package, Fund support in the form of additional resources would be limited in view of the present restrictions on the use of these resources.

The existence of segmentation restrictions places unduly rigid constraints on the Fund's ability to support debt operations, and their elimination could facilitate timely completion of difficult remaining debt cases. While the segmentation restrictions may have provided a mechanism to encourage balance among menu options in completed packages, even in the absence of these restrictions the Fund would still need to determine on a case-by-case basis whether a bank debt package qualified for Fund support, consistent with the guidelines. This assessment would also provide the opportunity to ensure that concerns expressed by some Directors regarding balance between debt and debt-service reduction are taken into account.

Some Executive Directors have suggested that the segmentation restrictions contained in the existing guidelines could be relaxed on a case-by-case basis as the need arises. However, given the need for uniformity of treatment for members, use of set-aside or additional resources in ways not currently envisaged in the guidelines could not be done on an "ad-hoc" basis; to allow such use for any member would require an amendment to the guidelines themselves, which must then be applied to all members on an even-handed basis. In addition, an early resolution of the issue would be helpful to ensure that parties involved in negotiations have a clear and consistent understanding of the framework for potential Fund support.

III. Proposed Approach

With the lifting of the segmentation requirements through a modification of the 1989 guidelines, both set-asides (including those already accumulated under existing arrangements) and additional resources could be used to support debt reduction operations, interest support for debt and debt-service reduction or principal collateralization for reduced-interest par bond exchanges. At the same time it would be made explicit in the revised guidelines that appropriate balance would be a factor to be taken into account by the Board in assessing whether a particular package qualified for Fund support. The modifications would take the form of a summing-up of the Board discussion of the present paper.

The decision by the Fund whether to support a particular debt and debt-service reduction package would continue to be made by the Executive Board on a case-by-case basis, taking account of all relevant factors. As

laid out in the May 1989 guidelines, in making a judgment on a request for Fund support, the Fund considers in particular three broad elements: the strength of economic policies; the scope for voluntary market-based debt-reduction operations that would help the country regain access to credit markets and attain external viability with growth; and an assessment as appropriate that such operations represent an efficient use of scarce resources.

Under the proposed approach, the concern expressed by some Executive Directors to ensure an appropriate balance between debt and debt-service reduction in bank debt packages would be taken into account at the time of Executive Board consideration of a request for Fund resources together with the general assessment of the package based on the three broad criteria mentioned above. This point would be clarified explicitly in the summing-up of the Board discussion endorsing the modification of the guidelines. Rather than seeking to establish fixed numerical guideposts for what would constitute appropriate balance, the staff would propose that the assessments of balance be based on a number of factors, including:

(i) whether the resulting allocation provides a debt-service profile after restructuring consistent with a country's likely medium-term debt-service capacity. This criterion would weigh against support of a package in which the debt relief was heavily front loaded, so that achievement of longer-term viability remained in doubt;

(ii) whether taken as a whole the package is cost effective. This criterion would prevent Fund support for a package in which bank choices were heavily skewed to an excessively expensive option;

(iii) whether the package would imply continued commercial bank involvement with the debtor country, in cases where such involvement would be appropriate and could be expected to provide the basis for a subsequent return of spontaneous private financing. This criterion would be relevant to avoiding an excessive shift of risk to official creditors; and

(iv) whether the menu of options included in the package provides banks with a sufficiently broad range of alternatives to ensure a high rate of participation in the package. This would rule out Fund support for packages with a very limited range of options that discouraged participation by the broad universe of banks.

The staff believes these factors reinforce the menu approach and also provide balance in the sense that the different interests of the debtor and the creditors, and of the various groups of creditors, are taken into account. As before, the member and its banks would allocate the options in a package between debt and debt-service reduction so as to tailor them to the needs of each case.

Elimination of segmentation provisions would mean that set-asides and additional resources would both be eligible to be used for the same operations, raising an issue of the priority of use between these two sources of funding. The staff proposes that priority be given to use of accumulated set-asides under an arrangement. Thus, additional resources would be considered only if accumulated set-aside resources were insufficient to assure adequate Fund financing of the package, taking into account the criteria specified in the 1989 guidelines, including the need to catalyze resources from other sources and for the member to contribute as feasible and the strength of the member's adjustment program. Acceleration of future set-asides would continue to be possible, but only if it were absolutely necessary, i.e., normally only after appropriate use of additional resources. The staff believes it is best to avoid acceleration if at all possible for several reasons. The decision in 1989 to include the possibility of acceleration was partly motivated by the constraints imposed by segmentation. In the absence of segmentation, it is preferable to keep the time structure of the program and financing intact. Also, applying the early repurchase provisions to accelerated set-asides should the Fund-supported program subsequently go off track has proven to be quite complicated in the past, especially because the Fund would request an early repurchase when the member can least afford to do so. 1/

In some cases where access under a stand-by or extended arrangement is relatively low, a country may prefer not to request the incorporation of set-aside provisions into the arrangement in view of the small amounts involved, even though it may intend to request additional resources to support a bank package at the appropriate time. Other than in such cases, however, it would generally be expected that set-asides would be included in the arrangement if a request for Fund support for debt operations was anticipated, and additional resources would be considered only if the country had made appropriate use of set-asides.

Removal of segmentation restrictions as proposed would not be expected to have a very large impact on the Fund's liquidity position. Most of the countries that are likely candidates for debt operations could be expected eventually to gain access to the same amounts of total Fund resources for debt operations as they would have under the present guidelines. 2/ Also, this modification of the guidelines would discourage the acceleration of set asides. The increased flexibility in the use that may be made of additional resources could mean that countries would tend to seek use of additional resources somewhat more quickly than otherwise would have been the case, if

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1/ In two of the four cases of acceleration of set-asides to date, relevant performance criteria have subsequently been missed, and the issue of an early repurchase has arisen. In both these cases, this served to complicate the member's situation at a time when its balance of payments position was deteriorating.

2/ As for example in the case of Argentina where the package needed to be reworked to be compatible with Fund financial support.

the proposed modification led to earlier agreements with banks on debt packages. The increased flexibility would not imply that the Fund would provide such resources for weaker adjustment efforts or on the basis of an insufficient record of performance.

IV. Consequential Changes in the Repurchase Expectation Decision

The proposed removal of the segmentation provisions would need to be reflected in the text of the decision on early repurchase expectations with respect to debt and debt-service reduction operations (Decision No. 9331-(89/167)). Currently, the text of this decision refers specifically to the use of set asides "for operations involving debt reduction" and to the use of additional resources "for interest support or for collateralization of principal in reduced interest par bonds." Under the proposal, both set asides and additional resources would be available for the purpose of financing operations involving debt reduction or interest support for debt and debt-service reduction or for collateralization of principal in reduced interest par bonds. Thus, the language in the preamble to the Decision and in Sections A and B would need to be modified accordingly. It should be noted that the decision to approve the use of set-asides or additional resources would no longer specify the specific operation within the overall package for which the different types of resources would be used. Rather, it would only require that the resources be used for any operations within the package which qualify for support under the guidelines.

Section C in the decision, dealing with the release of collateral financed with additional resources from the Fund, would also need to be adapted to clarify the manner in which the decision would be applied. This adaptation would apply only to collateral acquired after the removal of segmentation. This section of the decision covers situations in which collateral is released as the result of a second round of debt operations, such as a buy-back of collateralized instruments. Without an early repurchase decision, the released resources could be used for an unrelated purpose. Section C enables the Fund to decide that an early repurchase expectation exists if the total amount of collateral remaining after the release of collateral falls below the amount of additional resources from the international financial institutions (IFIs) used to finance the collateral still outstanding, unless the country applies the released additional resources to finance further debt and debt-service reduction

operations. 1/ This section of the decision currently applies only to additional resources, because of the nonadditional character of the set-aside resources under the guidelines, and it is intended to retain this feature.

Adaptations to this section are needed to ensure that Fund resources used to finance the purchase of collateral would still be subject to an early repurchase expectation if some or all of the collateral financed by additional resources were released and not used for subsequent debt operations. With the elimination of segmentation, it would no longer necessarily be clear a priori whether released collateral was financed through set-asides or additional resources. To remove any ambiguity, for the purposes of this decision, the amount of additional resources from the Fund that would be used to finance the purchase of collateral would need to be clearly established. The staff would propose that to the extent possible additional resources would be deemed to have been allocated to the financing of collateral. Specifically, this amount would equal the difference between the total amount of collateral and the collateral financed through additional resources provided by the other IFIs. 2/ Thus, if this difference were to exceed the total amount of additional resources from the Fund, then all of the additional resources would be deemed to have been used to finance collateral.

It is proposed that the changes in the guidelines on debt and debt-service reduction operations described in this paper be adopted by the Executive Board, and that they be reflected in the Summing Up of the Executive Board's discussion of the paper.

It is also proposed that the Executive Board adopt the following decision setting forth amendments of Decision No. 9331-(89/167) adopted December 19, 1989, as amended. 3/ The adoption of the changes in the guidelines and of the proposed decision requires a majority of the votes cast.

1/ For example, suppose the total amount of collateral is US$100 million, with US$40 million financed from the Fund and US$60 million from the country's reserves. If US$70 million of collateral were released as the result of buybacks, the remaining collateral would amount to US$30 million and US$10 million (US$40 million financed by the Fund less the unreleased amount of collateral of US$30 million) could be subject to an early repurchase expectation. If the US$10 million were used to finance further debt or debt-service reduction operations, there would be no repurchase expectation.

2/ If other international financial institutions modify their own guidelines on the use of additional resources the Fund staff would propose any needed modifications to the early repurchase decision at that time.

3/ The full text of Decision No. 9331-(89/167) is set forth in Annex I. The proposed additions are underscored and proposed deletions are stricken.

V. Proposed Decision

1. The introductory paragraph is amended to read as follows:

"In the context of the guidelines on the role of the Fund in the debt strategy, the Fund adopts the following decision on expectations of early repurchase by members with respect to purchases of additional resources under stand-by or extended arrangements or amounts set aside under such arrangements for use in debt and debt-service reduction operations involving (i) debt reduction, (ii) interest support or (iii) collateralization of principal in reduced interest par bond exchanges.

2. Section A, paragraph 1 is amended to read as follows:

"Whenever the Fund approves a member's request for purchases of additional resources or amounts set aside under a stand-by or extended arrangement pursuant to the Fund's guidelines on the role of the Fund in the debt strategy, the Fund shall specify in the decision approving the request the purposes for which, and the period of time within which, such set-aside amounts or additional resources can be used."

3. Section B, paragraph 4(a) is amended to read as follows:

"If the program of a member that has previously made accelerated purchases of amounts set aside under a stand-by or extended arrangement is off track on the date a purchase becomes available under the phasing provision in the arrangement, and is not back on track within 90 days after that date, the Managing Director shall report the matter to the Executive Board promptly after the expiration of the 90-day period."

4. A new paragraph 11 shall be added to Section C, to read as follows (the paragraphs of Section D to be renumbered accordingly):

"For purposes of this Section, and with respect to Fund resources made available in accordance with the amended guidelines on the role of the Fund in the debt strategy (Summing Up at ..., on ...), in cases where debt or debt-service reduction operations include the establishment of a collateral, any portion of the collateral that has not been financed from additional resources from international financial institutions other than the Fund shall be deemed to be financed first from additional resources from the Fund and, subsequently, from other resources."

ANNEX

DEBT AND DEBT-SERVICE REDUCTION OPERATIONS - EARLY REPURCHASE EXPECTATIONS

In the context of the guidelines on the role of the Fund in the debt strategy, the Fund adopts the following decision on expectations of early repurchase by members with respect to ~~(i)~~ purchases of additional resources under stand-by or extended arrangements ~~either for interest support or for collateralization of principal in reduced interest par bond exchanges and (ii) purchases of amounts set aside under such arrangements to support operations involving debt reduction:~~ or amounts set-aside under such arrangements for use in debt and debt-service reduction operations involving (i) debt reduction, (ii) interest support or (iii) collateralization of principal in reduced interest par bond exchanges:

A. *Failure to Use Resources for Specified Purposes*

1. Whenever the Fund approves a member's request for ~~(i)~~ purchases of additional resources or amounts set aside ~~to support operations involving debt reduction~~ under a stand-by or extended arrangement~~, or (ii) of additional resources under a stand-by or extended such as arrangement, either for interest support or for collateralization of principal in reduced interest par bond exchanges,~~ pursuant to the Fund's guidelines on the role of the Fund in the debt strategy, the Fund shall specify in the decision approving the request the purposes for which, and the period of time within which, such set-aside amounts or additional resources can be used.

2. If the member, having purchased such set-aside amounts or additional resources, has not used them by the end of the specified period of time for the specified purposes, the Managing Director shall, after consultation with the member, promptly report the matter to the Executive Board. In this report, the Managing Director shall recommend that the Executive Board decide that the member is expected to make an early repurchase of the set-aside amounts or additional resources that were not used for the specified purposes, or shall recommend such other action as may be appropriate.

3. The Fund may decide that the member shall be expected to repurchase the set-aside amounts or additional resources that were not used for the specified purposes within 30 days of the decision or within such longer period as the Executive Board may specify.

B. *Subsequent Derailment of Program*

4. (a) If the program of a member that has previously made accelerated purchases of amounts set aside ~~to support operations involving debt reduction~~ under a stand-by or extended arrangement is off track on the date a purchase becomes available under the phasing provision in the arrangement, and is not back on track within 90 days after that date, the Managing Director shall report the matter to the Executive Board promptly after the expiration of the 90-day period.

(b) For purposes of this decision, a member's program is off track if the member is unable to make a purchase under the arrangement because of (i) the nonobservance of a performance criterion, the noncompletion of a review or the failure to meet any other condition under the arrangement, or (ii) the cancellation of the arrangement by the member before the purchase; the program is back on track if the member is again able to make purchases under the arrangement.

(c) Subparagraph (a) shall not apply if, on the date the purchase becomes available, all set-aside amounts that were purchased by the member by virtue of the acceleration would already have become available to the member under the phasing provision in the stand-by or extended arrangement in the absence of the acceleration.

5. In the report submitted under paragraph 4 above, the Managing Director shall recommend such action as may be appropriate, including the possibility of an expectation of early repurchase of the accelerated set-aside amounts.

6. (a) In the event that the Executive Board, taking into account the member's economic and financial position, decides that the member shall be expected to repurchase accelerated set-aside amounts, the member would be expected to make the repurchase, to the extent that such amounts would not yet have become available to the member under the phasing provision in the stand-by or extended arrangement in the absence of acceleration, within a period specified by the Executive Board, provided that such period would not be less than 30 days. The Executive Board shall give special consideration to those cases where the program has gone off track because of circumstances beyond the control of the member.

(b) A member shall not be expected to repurchase pursuant to subparagraph (a) above if its program is back on track within the period specified in that subparagraph, or if the Executive Board determines that the member has already begun to implement measures designed to bring the program back on track.

(c) If the Fund finds that the program is back on track after the repurchase has been made under this paragraph, the amount of the stand-by or extended arrangement shall be increased by an amount equivalent to the repurchase, subject to such phasing as shall be specified.

C. *Release of Collateral Financed with Additional Resources*

7. The provisions of this section shall apply when a member has purchased additional resources to finance the establishment of a collateral, and any portion of such collateral is released, subject to the following conditions:

(i) the member has not fully repurchased these additional resources from the Fund; and

(ii) the amount of the aggregate collateral that remains after this release is less than a threshold amount equal to:

- the sum of outstanding disbursements to the member of additional resources from the Fund and of additional funds for debt and debt-service reduction from the World Bank and from regional development banks ("outstanding additional disbursements from IFIs"), minus

- any amounts that may have been used previously by the member for further debt or debt-service reduction operations in accordance with paragraph 8 below.

8. If the member has not used an amount equivalent to the difference between the threshold amount and the remaining aggregate collateral ("excess release") for further debt or debt-service reduction operations within 12 months of the release, the Managing Director shall, after consultation with the member, promptly report the matter to the Executive Board. In this report, the Managing Director shall recommend that the Executive Board decide that the member is expected to make an early repurchase, or shall recommend such other action as may be appropriate.

9. The member will inform the Fund of the release of any portion of the aggregate collateral within 5 working days of such release, and of any use of the excess release for further debt or debt-service reduction operations within 30 days of such use.

10. The Fund may decide that the member shall be expected to repurchase, within 30 days of the decision or within such longer period as the Executive Board may decide, an amount equivalent to the portion of the excess release that was financed with additional resources from the Fund. For purposes of this section, the portion of the excess release financed with additional resources from the Fund shall be calculated by applying the same proportion to the excess release as the amount of the member's outstanding purchases from the fund of additional resources bears to the total amount of outstanding additional disbursements from IFIs to the member.

11. For purposes of this Section, and with respect to Fund resources made available in accordance with the amended guidelines on the role of the Fund in the debt strategy (Summing Up at EBM/93..., November ..., 93), in cases where debt and debt-service reduction operations include the establishment of a collateral, any portion of the collateral that has not been financed from additional resources from international financial institutions other than the Fund shall be deemed to be financed first from additional resources from the Fund and, subsequently, from other resources.

D. *General Provisions*

12. The Fund shall not approve, and the Managing Director shall not recommend for approval, a request for the use of the general resources of the Fund by a member that is failing to meet a repurchase expectation pursuant to paragraph 3, 6, or 10 above.

13. (a) Provision shall be made in stand-by and extended arrangements for the suspension of further purchases under the arrangement whenever a member fails to meet a repurchase expectation pursuant to paragraph 3, 6, or 10 above.

(b) Paragraph 5 of the standard form of the stand-by arrangement in Attachment A to Decision No. 6838-(81/70) adopted April 29, 1981, as amended, shall be modified as follows:

> "(Member) will not make purchases under this stand-by arrangement during any period of the arrangement in which (member) has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the Guidelines on Corrective Action in respect of a noncomplying purchase or pursuant to Decision No. 9331-(89/167), as amended."

(c) Paragraph 5 of the standard form of the extended arrangement in Attachment B to Decision No. 6838-(81/70) adopted April 29, 1981, as amended, shall be modified as follows:

> "(Member) will not make purchases under this extended arrangement during any period of the arrangement in which (member) has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the Guidelines on Corrective Action in respect of a noncomplying purchase or pursuant to Decision No. 9331-(89/167), as amended."

14. If a repurchase pursuant to the expectation under paragraph 3, 6, or 10 above has not been effected within the specified period of time, the Managing Director shall submit promptly a report to the Executive Board accompanied with a proposal on how to deal with this matter.

15. Nothing in this decision shall be deemed to limit the power of the Fund to take any other action that may be taken pursuant to the Fund's Articles.