

THE WORLD BANK  
Washington, D.C. 20433  
U.S.A.

BARBER B. CONABLE  
President

July 18, 1989

MEMORANDUM TO THE EXECUTIVE DIRECTORS

Subject: Operational Guidelines and Procedures for the Use of Resources of the Debt Reduction Facility for IDA-Only Countries

I. Introduction

1. On June 29, 1989, the Executive Directors agreed to recommend to the Board of Governors that \$100 million of IBRD FY89 net income be transferred to a Facility to be administered by IDA to facilitate commercial debt reduction for IDA-only countries.<sup>1</sup> In response to the Directors' request, this memorandum proposes criteria for eligibility and guidelines and procedures to be used by the Association in the use of these resources. Commercial debt referred to here means external medium and long term debt owed to commercial creditors by, or with the guarantee of, the debtor government, but not otherwise guaranteed, collateralized or secured by creditor governments, by other third parties, or by assets.

2. Section II summarizes the key issues relating to commercial debt in IDA-only countries and the potential impact of debt reduction financed by the Facility or other external sources. Section III sets out the proposed eligibility for and allocation of the Facility's resources. Section IV indicates the modalities of debt reduction support to be provided by the Facility. Section V describes the proposed procedures for Board approval of specific debt reduction operations. The final section summarizes Management's recommendations.

II. Commercial Debt in IDA-Only Countries

3. In IDA-only<sup>2</sup> countries, commercial debt constitutes a relatively small portion of the total external debt; on average, it is less than 10%, but can range up to 30%.<sup>3</sup> However, due to the non-concessional nature of the terms of this debt compared to the more concessional official debt, the contractual service burden of commercial debt is often relatively large. Moreover, few mechanisms exist for easing the burden of this commercial debt, in contrast to the Paris Club arrangements for bilateral official debt. In general, the reschedulings that have been obtained by low income countries from commercial banks have been less favorable than those obtained by middle income debtors. This is due partly to the weaker bargaining

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1/ See "Allocation of FY89 Net Income and Plan for FY90", R89-128, June 9, 1989. ("Net Income Allocation Paper").

2/ IDA-only countries are defined as those countries below the operational threshold (i.e. currently \$580 per capita) for which no IBRD lending is projected over the next few years.

position of these countries and partly to their greater dependence on commercial banks for trade credits and other financial services.<sup>4</sup> Despite efforts by low income countries to service their commercial debt, or to reach agreements with their commercial creditors, not all countries have been able to make contractual payments on a regular basis, and arrears on various categories of debt have accumulated.

4. This situation can impose a variety of costs on the IDA-only debtors. There is a high implicit marginal tax on any increment to foreign exchange earnings due to the unmet claims of the commercial creditors. Where countries that are unable to generate current account surpluses are making payments to commercial creditors, such payments are implicitly being funded by concessional official flows. Access to trade and other short term credit often becomes restricted and more costly. Access to official support may also be restricted because of the arrears situation with commercial creditors. The fact that countries are forced to accumulate arrears may risk encouraging undesirable attitudes about the repayment of debt in general. Reduction of the commercial debt in these countries would mitigate many of these problems and may offer material benefits to these countries.

5. Due to the more episodic nature of commercial borrowing and institutional weaknesses in many of these countries, the quality of data on the commercial debt varies widely. Commercial banks' claims (excluding trade finance) on IDA-only countries is estimated to be in the range of \$7 to \$11 billion, with a substantial portion of this being externally guaranteed. The amount of debt likely to be eligible for reduction is on the order of \$2-3 billion. While some low income countries have reliable debt data, many do not. Although the poor quality of information on commercial debt need not prevent IDA from proceeding with operations to support debt reduction, the problems with such data may hinder or delay the implementation of several debt reduction operations. The Association has already begun to assist a number of these countries to improve their debt management and analytic capabilities.

6. Commercial creditors' claims on the IDA-only countries typically do not represent major exposure in relation to their overall balance sheets. Most commercial banks can be expected to have adequately provisioned against their claims on IDA-only countries which have been in a chronic and protracted state of arrears. Moreover, any further losses would be small relative to their balance sheets. Very little secondary market trading appears to have taken place with IDA-only country debt. Generally, it has involved inter-bank portfolio adjustment. Depending on the extent to which these countries are servicing their debt, the discounts reported vary from 50% to 95%. Debt of countries with better payments records is naturally quoted at lower discounts.

### III. Eligibility and Allocation of Resources to Debt Reduction

7. As stated in the Net Income Allocation Paper, all IDA-only countries with a heavy debt burden would be eligible for support from the Facility. However, support by the Facility for debt reduction would be decided on a case-by-case basis taking into account the following criteria:

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4/ Middle income countries also require access to these services, but often have more leverage in negotiations with commercial banks.

- i) The existence of a medium term adjustment program acceptable to the Association as, for example, demonstrated by a PFP, structural adjustment program, or an ESAF program, and
- ii) the existence of a strategy for debt management satisfactory to the Association that:
  - a) Includes a program for resolving the commercial debt problem in a comprehensive manner based on funds provided by the Facility and other available resources.
  - b) Provides for substantial debt relief from official bilateral creditors through an agreement with the Paris Club, preferably one that offers the most favorable treatment accorded by the Paris Club, including the so called "Toronto Terms" where applicable.
  - c) Will materially enhance the country's growth and development prospects.

8. As in the case of IBRD support for debt reduction in the middle income countries, the extent of the support that the Association will provide out of Facility resources will be determined on a case-by-case basis. The Association will give particular weight to two factors in assessing the potential benefits of a proposed debt reduction operation: the impact of actual commercial debt service payments on the country's ability to achieve adequate levels of real economic growth; and the degree of confidence that can be placed in the accuracy and completeness of the data concerning the debt targeted by the proposed operation. Substantial discounts or cash flow relief will have to be realized to justify use of limited Facility resources.

9. Since funds are limited, Facility resources available to any country should not exceed \$10 million unless there are exceptional circumstances providing strong justification for a greater level of support. It should be expected that the recipient country would make every effort to mobilize other resources made available for this purpose by other donors. If funds allocated to a country are not disbursed for approved debt reduction in an agreed time period (anticipated to be six months), they would become available for support of debt reduction elsewhere. The Facility resources should initially be available for debt reduction support for a period of three years from the time the Facility is approved. Any funds not disbursed within such period should be available to IDA for use in its general operations. While it would be permitted for resources provided by other donors to support debt reduction operations financed by the Facility to be deposited in the Facility, it is expected that donors would normally make available such resources directly to the recipients in parallel operations.

#### IV. Modalities of Debt Reduction Support

10. Facility resources will be made available on a grant basis so they will have the maximum impact in achieving as much debt reduction as possible. It is expected that most operations will take place through cash buybacks of commercial debt at substantial discounts. However, in exceptional circumstances, debt exchanges may be supported through the use of Facility resources to collateralize principal where such support constitutes a more efficient use of the resources.

11. As in the case of support for IBRD debt reduction in the heavily indebted middle income countries, the Association will seek to minimize its direct involvement in debt reduction negotiations between creditors and the debtor country. In view of the likely inexperience of many low income countries in addressing the complex technical issues that arise in debt reduction operations, it is likely that technical assistance will be required to assist the member country improve and analyze its debt data, to identify options in developing its debt strategy, and to evaluate alternative debt reduction approaches. In cases where independent advice cannot be obtained on reasonable terms or with adequate dispatch, technical assistance may be provided by the Association itself. Specific technical assistance in dealing with markets on individual transactions is expected to be obtained by the countries from independent financial and legal advisers.<sup>5</sup> In all instances, the Association will stand ready to provide information to the parties to the negotiations about the Association's perception as to the status of the relevant country's adjustment program, the country's financing requirements and prospects and the amount of support that may be available.

#### V. Structure of the Facility and Procedures for Board Approval

12. The terms of the Facility would be established by a joint Resolution of the Executive Directors of the Bank and IDA. The use of the funds transferred to the Facility will be subject to the terms of the joint Resolution and to the general guidelines to be approved by the Executive Directors of IDA and set out in paragraph 14 of this Memorandum. IDA is to be the trustee of the Facility.

13. In view of the limited amount of Facility resources that would be available to any one country, it is likely that there would only be one debt reduction operation by a country, the timing of which would be based on the negotiations with the commercial banks. It would therefore be reasonable to expect to make Facility resources available under a

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<sup>5/</sup> Funds for such assistance may be provided as part of the Association's regular technical assistance financing activities in such countries or obtained from other sources such as, for example, UNDP.

free standing grant arrangement to support the debt reduction operation.<sup>6</sup> When the Association is contemplating supporting debt reduction operations in a specific country to be supported by Facility resources, Directors will be so informed in the President's Memorandum of the next operation being presented to the Board, or if no operation is planned in a relevant timeframe, through a separate brief memorandum. The information provided at this stage would include a brief review of the country's adjustment program, its medium term financing needs and prospects, an assessment of the expected benefits to be obtained from the proposed operation, and the amount of Facility resources likely to be needed for eligible debt reduction operations. Once adequate details are available, specific debt reduction operations would be submitted for the approval of IDA's Executive Directors. For this purpose, a staff appraisal report would be prepared covering material similar to that mentioned in paragraph 12 of the "Guidelines" paper for middle income countries. See para. 12 of the "Guidelines" paper of May 21, 1989 (R89-104).

"... The appraisal would be based to the extent possible on such considerations as analysis of improvements in external (and internal) cash flows, estimates of rates of return, analysis of the impacts of reduced service payments on increased investment and imports, estimates of enhanced growth and development prospects, ... and a review of the impact of the debt reduction program on the country's overall creditworthiness. The objective would be to show the material benefits to the country's development prospects due to debt reduction over the medium term."

## VI. Recommendations

14. Management recommends that:

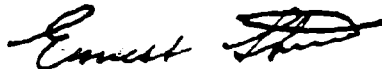
- (a) The Bank and the Association establish a Facility to be administered by IDA as trustee, in accordance with operational guidelines approved by the Association's Executive Directors as follows:
  - (i) The Association would agree to make available Facility resources for the support of operations reducing public external medium and long term commercial debt (not otherwise guaranteed or collateralized) in any IDA-only country which has a large external debt burden and which satisfies the criteria stated in paragraph 7.

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<sup>6/</sup> Also the relative infrequency of IDA operations in some countries would make associating the debt reduction with a regular operation more difficult.

- (ii) The Association would determine the amount of Facility resources to be made available in support of a debt reduction operation on a case-by-case basis, provided, however, that at most \$10 million of IDA funds would be made available to a country, unless there are exceptional circumstances providing strong justification for a greater level of support. Funds allocated to a country but not disbursed within six months would, unless otherwise agreed by the Association, become available for support of debt education elsewhere.
  - (iii) Facility resources would be made available on a grant basis and disbursed through "stand-alone" operations.
  - (iv) When the Association is ready to begin preparation of a debt reduction operation in an eligible country, a memorandum would be circulated to the Association's Executive Directors which would include a discussion of the country's medium term financing needs and prospects, an assessment (to the extent feasible) of the expected benefits to be obtained from the proposed operation and an estimate of the amount of Facility resources likely to be needed. When adequate details of a debt reduction operation are available, an appraisal thereof would be presented to the Board for approval of the grant of Facility resources for that operation, which would be disbursed as needed.
- (b) The Executive Directors of the Bank and IDA adopt the Resolution attached hereto.

Barber B. Conable  
President



by Ernest Stern

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

INTERNATIONAL DEVELOPMENT ASSOCIATION

(DRAFT)

Resolution No. 89-\_\_

Resolution No. IDA 89-\_\_

Debt Reduction Facility  
for IDA Only Countries

WHEREAS:

(A) It is desirable to establish a Debt Reduction Facility for IDA Only Countries (the Facility) administered by the International Development Association (the Association) as a trust to provide grants to assist in the reduction of commercial debt of certain members of the Association;

(B) The Executive Directors of the International Bank for Reconstruction and Development (the Bank) are proposing to the Board of Governors of the Bank to adopt a resolution authorizing the transfer by the Bank to the Facility by way of grant the equivalent of \$100 million;

(C) Subject to the adoption by the Board of Governors of the Bank of the resolution referred to in paragraph B of this Preamble, the Executive Directors of the Bank and the Association have resolved to make the said transfer to the Facility for disbursement by the Association for the purposes of the Facility (Resolution No. 89-9 and Resolution No. IDA 89-2);

(D) Members of the Association and others (the Contributors) may provide additional resources to the Facility (the Contributions); and

(E) The Bank and the Association are prepared to establish the Facility and the Association is prepared to be trustee and administer the Facility on the terms and conditions set forth in this Resolution.

NOW THEREFORE it is hereby resolved that, subject to the adoption by the Board of Governors of the Bank of the proposed resolution referred to in paragraph B of the Preamble:

Establishment of the Facility

1. The Facility is hereby established constituted by the funds which shall from time to time be contributed in accordance with the provisions of this Resolution, and any other assets and receipts of the Facility.

2. The Association shall hold and administer such funds, assets and receipts in trust (in such capacity, the Trustee) for the benefit of member countries of the Association to which such funds are made available, and the Association shall manage and use them only for the purpose of, and in accordance with, the provisions of this Resolution, keeping them separate and apart from all other accounts and assets of the Association.

#### Contributions to the Facility

3. Subject to the adoption of the resolution referred to in paragraph B of the Preamble and in accordance with the resolutions referred to in paragraph C of the Preamble, the Bank shall make the equivalent of \$100 million available to the Facility.
4. The Trustee is authorized to accept Contributions to the Facility from Contributors other than the Bank as follows:
  - (a) The Trustee shall enter into an agreement with each Contributor, in such form as shall be satisfactory to the Trustee, whereby such Contributor agrees to pay its Contribution to the Facility in a specified amount in accordance with the terms of this Resolution.
  - (b) Contributions shall be denominated in terms of the United States Dollar.

#### Payment of Contributions

5. Payment of each Contribution shall be made as follows:
  - (a) Payment shall be made in the form of cash, non-interest bearing notes or other obligations of the Contributor payable on demand and to the order of the Association, as Trustee of the Facility, and deposited with the depository of the Association in the member country concerned, or in the case of a non-member Contributor, as directed by the Trustee.
  - (b) Payment of the full amount of each Contribution shall be made at such time and in such manner as shall be agreed with the Trustee.

#### Operation of the Facility

6. All amounts credited to the Facility shall be used by the Trustee exclusively for the purpose of making grants out of the Facility's resources (Facility Grants) to member countries of the Association which are eligible for Facility Grants, as determined by the Trustee in accordance with operational guidelines approved by the Association's Executive Directors and as specifically agreed by the Trustee with a Contributor under paragraph 4 (a) of this Resolution with respect to its contribution.



7. Facility Grants shall be made as follows:

- (a) Each Facility Grant shall be: (a) approved by the Association's Executive Directors, and (b) made for the purpose of a clearly identified debt reduction operation.
- (b) Each Facility Grant shall be evidenced by a separate grant agreement between the recipient and the Trustee, indicating in particular that the resources have been provided from the Facility.
- (c) Facility Grants shall be denominated in United States Dollars.

Administration of the Facility

8. (a) The Trustee shall establish and maintain appropriate records and accounts to identify the resources of the Facility, the commitments to be financed out of the Facility, and the receipts and disbursements of funds in the Facility;
- (b) Pending disbursement of Facility Grants, the Trustee may invest funds held in the Facility, in accordance with the investment authority of the Association.
- (c) The income from such investments shall be credited to the Facility.
- (d) On the termination of the Facility pursuant to paragraph 11 of this Resolution, any surplus assets of the Facility shall be forthwith transferred to the general resources of the Association.

Reports

9. (a) The Trustee shall, as soon as practicable after the end of each fiscal year of the Association, furnish to the Bank and each Contributor: (i) a report on the progress of operations financed from the Facility; and (ii) a detailed financial statement for the Facility, together with an opinion of the Association's external auditors on such statement.
- (b) After the Facility Grants shall have been fully disbursed, the Trustee shall as soon as practicable furnish to the Bank and each Contributor a report on the operations financed from the Facility.

Parallel Financing Arrangements

10. The Trustee is authorized to enter into arrangements, on such terms as shall be determined by the Trustee, with members of the Association and other donors in cases where such donors are prepared to make available grants directly to a member country of the Association that

is a recipient of a Facility Grant in order to cofinance a debt reduction operation on a parallel basis with the Facility Grant.

Termination

11. The functions of the Association as Trustee of the Facility shall terminate, except for action necessary for winding up the activities of the Facility in an expeditious and orderly manner, within three years from the date of this Resolution, unless the Executive Directors of the Association decide to extend such period.

## SELECTED DEBT RELATED DATA ON ALL IDA-only COUNTRIES a/

	Public and Publicly Guaranteed Medium and Long-term Debt (PPD) US \$(million)	Private Creditors			Private Creditors / PPD (%)	Estimated Uninsured Commercial Bank Loans d/ US \$(millions)
		Suppliers' Credits US \$(millions)	Financial Markets b/ US \$(millions)	Total c/ US \$(millions)		
BANGLADESH	8,851.0	166.0	53.0	219.0	2.5%	2.5
BENIN	929.2	29.5	365.1	394.9	42.5%	34.8
BHUTAN	40.7	0.0	0.0	0.0	0.0%	0.0
BOLIVIA BOLIVIA e/	4,599.0	77.0	1,006.0 222.0	1,083.0	23.5%	222.0
BURKINA FASO	794.0	9.0	29.0	38.0	4.8%	3.0
BURUNDI	718.2	1.3	18.2	19.5	2.7%	N/A
CAPE VERDE	120.6	0.0	2.9	2.9	2.4%	N/A
CENTRAL AFRICA	520.3	24.1	1.6	25.6	4.9%	N/A
CHAD	269.6	25.8	16.8	42.7	15.8%	0.4
COMOROS	187.7	0.0	0.2	0.2	0.1%	N/A
DJIBOUTI	152.0	0.0	3.0	3.0	2.0%	N/A
EQUAT. GUINEA	174.9	4.0	4.8	8.8	5.0%	N/A
ETHIOPIA	2,434.0	212.0	185.0	406.0	16.7%	140.1
GAMBIA	272.9	1.3	15.4	16.7	6.1%	8.6
GHANA	2,207.1	84.8	187.5	272.2	12.3%	110.3
GUINEA	1,616.5	80.9	17.6	98.6	6.1%	5.7
GUINEA-BISSAU	390.7	1.6	80.5	82.1	21.0%	N/A
GUYANA	874.0	48.0	115.0	197.0	22.5%	85.2
HAITI	673.0	1.0	66.0	68.0	10.1%	4.7
KENYA	4,481.5	169.8	608.6	778.3	17.4%	56.3
LAO	736.0	4.0	0.0	4.0	0.5%	0.0
LESOTHO	237.0	8.0	9.0	17.0	7.2%	2.9

## SELECTED DEBT RELATED DATA ON ALL IDA-only COUNTRIES a/

	Public and Publicly Guaranteed Medium and Long-term Debt (PPD) US \$(million)	Private Creditors			Private Creditors / PPD (%)	Estimated Uninsured Commercial Bank Loans d/ US \$(millions)
		Suppliers' Credits US \$(millions)	Financial Markets b/ US \$(millions)	Total c/ US \$(millions)		
LIBERIA	1,151.9	2.9	194.1	196.9	17.1%	123.0
MADAGASCAR	3,113.5	78.8	195.9	274.7	8.8%	125.5
MALAWI	1,154.5	7.7	41.1	48.8	4.2%	25.3
MALDIVES	61.8	1.3	6.6	8.0	12.9%	5.8
MALI	1,847.3	26.4	33.5	61.2	3.3%	4.8
MALRITANIA	1,868.3	76.3	50.7	127.0	6.8%	7.0
MOZAMBIQUE f/	3,694.5	397.6	805.2	1,202.8	32.6%	174.2
MYANMAR	4,257.0	139.0	224.0	363.0	8.5%	10.4
NEPAL	902.0	4.0	31.0	35.0	3.9%	7.3
NIGER	1,258.5	4.2	226.5	230.7	18.3%	128.5
RWANDA	544.0	4.0	7.0	11.0	2.0%	N/A
SAO TOME & PR	83.9	0.0	0.5	0.5	0.6%	N/A
SENEGAL	3,067.6	1.6	257.0	258.7	8.4%	124.2
SIERRA LEONE	512.8	52.0	35.2	87.2	17.0%	3.3
SOLOMON Is.	85.0	2.4	15.0	17.4	20.5%	14.3
SOMALIA	2,288.4	14.1	72.0	167.1	7.3%	19.8
SRI LANKA	4,109.0	151.0	569.0	720.0	17.5%	238.7
SUDAN	7,876.3	4.0	1,673.1	1,677.1	21.3%	26.7
TANZANIA	4,067.8	253.8	175.7	429.7	10.6%	1.1
TOGO	1,042.1	1.3	80.9	82.2	7.9%	43.3
UGANDA	1,116.0	35.2	22.4	57.6	5.2%	N/A
VANUATU	14.6	0.1	1.5	1.6	11.0%	1.2

SELECTED DEBT RELATED DATA ON ALL IDA-only COUNTRIES a/

	Public and Publicly Guaranteed Medium and Long-term Debt (PPD) US \$(million)	Private Creditors			Private Creditors / PPD (%)	Estimated Uninsured Commercial Bank Loans d/ US \$(millions)
		Suppliers' Credits US \$(millions)	Financial Markets b/ US \$(millions)	Total c/ US \$(millions)		
WEST SAMOA	71.8	0.0	2.3	2.3	3.2%	0.8
YEMEN ARAB REP	2,155.0	0.0	76.0	76.0	3.5%	70.0
YEMEN DEM REP	1,669.0	0.0	0.0	0.0	0.0%	0.0
ZAIRE	7,334.3	178.4	700.0	878.4	12.0%	382.8
ZAMBIA	4,353.9	252.8	357.2	610.0	14.0%	221.0
<b>TOTAL</b>	<b>90,980.7</b>	<b>2,637.0</b>	<b>8,638.6</b>	<b>11,402.4</b>		<b>2,435.5</b>

a/ Source : World Debt Tables (1988-89) unless noted. Figures are as of December 31, 1987, which are the latest available.

b/ Loans from private banks and other private financial institutions as well as publicly issued and privately placed bonds or similar instruments.

c/ Suppliers' Credits and Financial Markets do not always add up to the total owed to Private Creditors because of loans from other sources like external liabilities created through nationalization and unclassified debts to private creditors.

d/ Rough estimate using variable rate debt owed to financial institutions as proxy from World Bank Debtor Reporting System, May 18, 1989.

e/ Current estimate following first buyback operation and debt equity conversions.

f/ Not in the World Debt Tables. Information made available by Mozambique authorities.