INTERNATIONAL MONETARY FUND

Assessing Public Sector Borrowing Collateralized on Future Flow Receivables

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(in consultation with other departments)

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I. INTRODUCTION

1. **This paper aims to help staff assess the appropriateness of collateralizing[1] public sector borrowing with future receipts.** Because of the complexity and evolving nature of such borrowing, this paper does not aim to provide a general Fund position. Rather, it aims to provide the basis on which to judge each case individually and to promote consistency in the Fund's treatment of collateralized borrowing in program cases.

2. **The future receipt that is collateralized could be almost anything, from oil export proceeds to lottery ticket sales.** Typically, the future receipt is in foreign currency, the associated transactions occur under a foreign jurisdiction and the borrowing is overcollateralized to enhance the arrangement's creditworthiness.

3. **This paper focuses on borrowing collateralized with future receipts, not with existing assets.** Collateralized borrowing includes both borrowing collateralized on existing assets (e.g., buildings) and on future receivables (e.g., next year's oil revenue). The focus of this paper is on the latter because it is the more common form of collateralized borrowing by public sector entities (see Ketkar and Ratha, 2001) but also because existing assets are not likely to be offshore. Also excluded from this paper are standard trade financing (which is usually short term and where creditors have liens on the goods concerned) and limited-recourse project financing (where the debt service depends entirely on the returns of the project concerned).

4. **Collateralized future receipts (CFR) arrangements by the public sector can be "direct" or "indirect."** Direct CFR arrangements typically involve the pledge of specified future receipts as collateral to secure liabilities owed to a creditor which gives the creditor the right to collect upon such assets in the event of default. However, this type of direct CFR arrangement may run counter to negative pledge clauses in loans extended by multilateral development banks, bond contracts, and bank loan agreements. As a result, CFR borrowings are often structured in a manner that they no longer give rise to claims for payment against the public sector and therefore are beyond the coverage of negative pledge clauses (indirect CFR arrangements).

5. **CFR arrangements are common in the commercial sector, but have only recently begun to grow in the public sector, and several cases examined by staff raised concerns that led staff to advise against such arrangements.** The Board's view has also been cautious. In the discussion of a Board paper on "Involving the Private Sector in Forestalling and Resolving Financial Crises," Directors considered that "collateralized borrowing, if held under appropriate restraint, could be a helpful device for regaining capital market access during difficult periods, and could pave the way for uncollateralized borrowing."[2] However, Directors also noted that "extensive granting of collateral reduces a country's flexibility in

[1] "Collateralized" borrowing is also termed "asset-backed" or "securitized."
[2] BUFF/99/122, September 1999, page 4.

mobilizing and managing foreign exchange and could increase its potential vulnerability to shocks."[3] Directors also encouraged staff to continue to monitor developments in this area.

6. **The Fund may be especially concerned about CFR borrowing by the public sector** in cases where it might threaten a member's capacity to repay and because CFR borrowing is nonconcessional (which is especially problematic for PRGF arrangements). There may also be legal issues, such as incompatibility with negative pledge clauses, as well as important macroeconomic, fiscal, and capital market considerations.

7. **While the Fund is mostly focused on CFR borrowing by the sovereign, public enterprise CFR borrowing could also be a source of concern.** Public enterprises may be a conduit for sovereign borrowing, their borrowing may carry an implicit or explicit government guarantee, and the enterprise may be engaged in quasi-fiscal activity.

8. The paper is structured as follows. Section II presents some characteristics of CFR borrowing, Section III discusses the various pros and cons of CFR borrowing, and Section IV examines some program design and procedural issues.

[3] BUFF/99/122, September 1999, page 6.

II. Characteristics of Collateralized Future Receipts Arrangements

A. Characteristics of a Typical Collateralized Future Receipts Arrangement

9. **In a typical *direct* CFR arrangement, a public sector entity creates security over specified future receipts to secure the payment of principal and/or interest and other charges on certain indebtedness owed to a specified creditor.** The security interest could take many forms such as lien, pledge, charge, assignment, title retention, and other preferential arrangement having the practical effect of giving a specified creditor a priority claim over an asset of the borrower.

10. **In a typical *indirect* CFR arrangement, the originator (e.g., a public sector entity or the government itself) sells its rights and interests in future receivables to an offshore entity created specifically for this purpose, called a special purpose vehicle (SPV), for an up-front price (see Figure 1).** The SPV finances its purchase by issuing debt securities whose service is collateralized by the receivables. The originator provides irrevocable instructions to foreign importers that purchase its exports requiring them to make payments to an escrow account controlled by the arrangement's trustee.

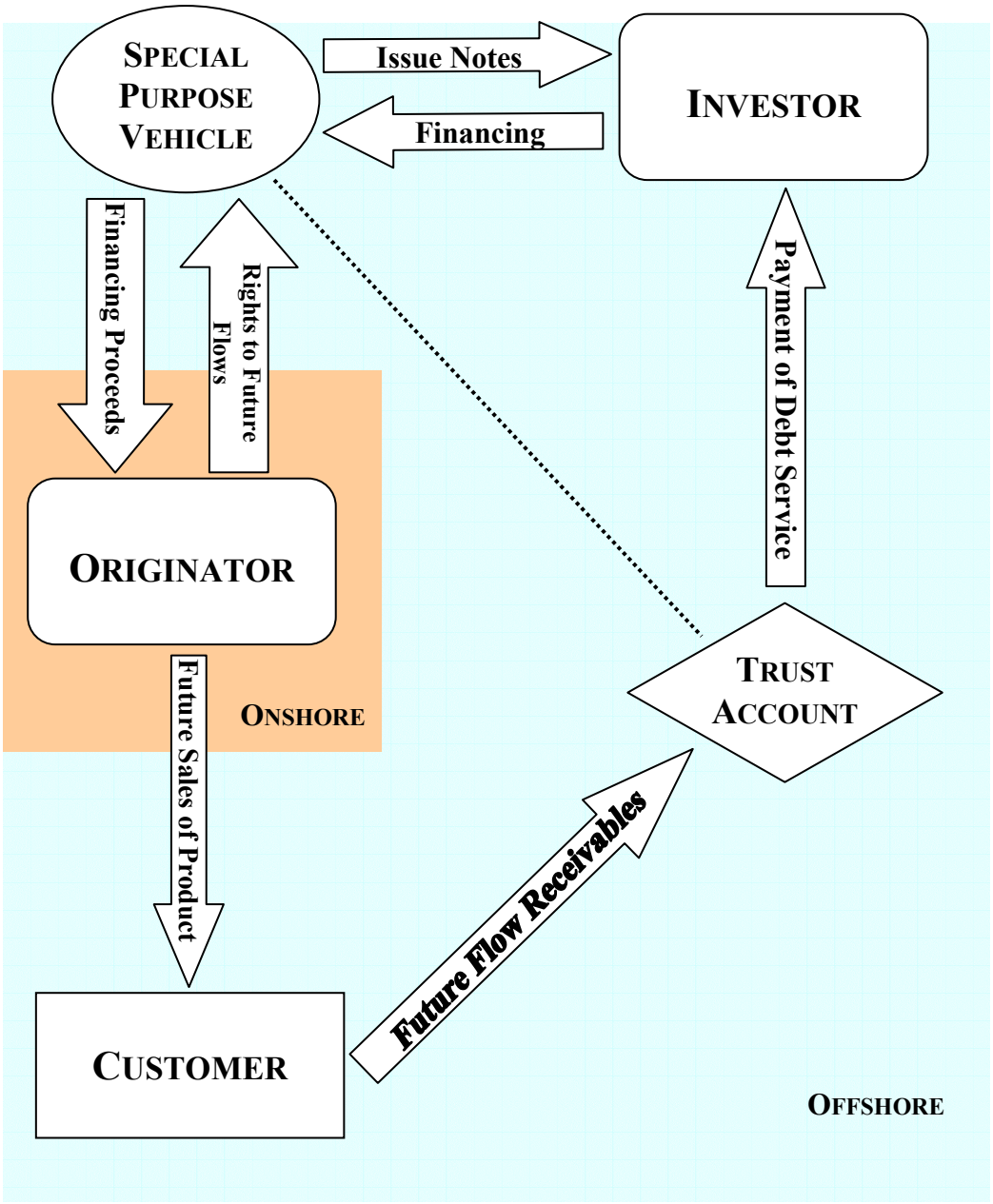
11. **Indirect CFR arrangements also typically shift jurisdiction over foreign-currency payments to a foreign court system trusted by investors, which makes them especially difficult to restructure.** The documents of the arrangement, including the originator's payment instructions, can have the force of contracts in foreign jurisdictions, binding companies that have specific payment obligations to the originator to make payments into the trustee account. Indirect collateralized borrowing arrangements can also be under domestic law. In terms of contract enforceability, such domestic law arrangements can be considered as more vulnerable to restructuring than offshore collateralized debt but less so than noncollateralized debt.

12. **Different types of future receivables can be used as security.** In declining rank of certainty such future receipts may include: (1) crude oil[4] and other mineral receivables, (2) airline ticket, telephone, credit card, or electronic remittances receivables, (3) other export receivables, and (4) government revenues.

13. **The pricing of the arrangement depends on the assessment of risk and typically the originator's desire to obtain a high credit rating results in the arrangement being overcollateralized.** In preparation of a CFR arrangement, stress tests are usually conducted to determine how secure the collateral is and hence the required degree of over-collateralization. Examples of collateralized borrowing outstanding for emerging-market countries show a collateralization ratio that ranges from two to six times, with a typical arrangement being three to four times overcollateralized. To give further comfort to

[4] Unlike a forward sale of oil, borrowing collateralized on future oil revenue involves an immediate transfer of principal and does not necessarily involve the fixing of the future oil price.

Figure 1. Structure of a Typical Indirect Collateralized Future Receipts Arrangement[5]



[5] Figure taken from Chalk, 2002.

the creditor, there is either a minimum balance on the escrow account of a designated amount (usually at least twice the scheduled periodic debt payment), or the trustee first pays debt service to creditors and then transfers any excess receipts to the SPV.

14. **The normally irrevocable nature of CFR borrowing arrangements gives creditors more confidence that payments will be made without delay or interruption for the duration of the arrangement, and this usually allows the debtor to mobilize credit below the normal sovereign spread.** The rating of the security issued by the SPV is determined by many factors, including the nature of the receivable, the degree of overcollateralization, redirection of payment risk, the rating of the sovereign, and the rating of the receivable-generating process. Ratings of individual tranches can be further enhanced by the use of insurance and/or subordination. It is possible to collateralize only the coupon payments, but in most cases collateralization applies to both the coupon and the principal.

B. Some Stylized Facts on Collateralized Borrowing

15. **Collateralized borrowing by the public sector in developing and emerging-market countries is considerable.** According to one data source,[6] at end-June 2002, such bonds and loans amounted to $28.8 billion, about 6.5 percent of total bonds and loans outstanding for the countries listed in Table 1 and Figure 2.[7]

16. **Public sector collateralized borrowing usually occurs through public enterprises.** Of the 37 countries with outstanding collateralized bonds and loans, only 4 had issuances by the sovereigns directly, while 33 used public enterprises; sovereigns issued 13 percent of bonds and 6 percent of loans. In several cases, public enterprise borrowing was undertaken by financial subsidiaries of public enterprises (e.g., Brazil, Mexico, and Venezuela).

17. **Collateralized loans outnumber collateralized bonds, both in value terms and as a proportion of total debt outstanding to developing and emerging-market public sector entities.** As of end-June 2002, total collateralized loans stood at $14.8 billion and total

[6] The source used is Capital Data (commonly known as the Bond-Equity-Loan or BEL database), a commercially available data base. The dataset covers some 30,000 assets issued in the international private capital markets by 75 developing and emerging market countries. The sub-sample used here is confined to: (1) bonds and loans; (2) assets issued by sovereigns and public enterprises; (3) assets issued for general financing purposes, i.e., excluding project financing (defined in the database as "no recourse or limited liability undertakings by a group of sponsors"); and (4) excluding participation by resident banks and export credit agencies. The database has limitations, as evidenced by discrepancies with information supplied by country teams, which raise some doubts about the comprehensiveness and the accuracy of classification (e.g., project vs. nonproject loans). In addition, it does not allow the distinction of collateralized borrowing by public enterprises undertaken for policy purposes (including on-lending to government) from borrowing to finance their own operations (see Section III.D).

[7] The information presented in Table 1 refers to borrowing collateralized both on future flows and existing assets and covers both direct and indirect CFR arrangements.

Table 1. Collateralized Bonds and Loans of Selected Countries 1/ 2/
(Stock as of July 1. 2002)

Country	Bonds				Loans 3/			
	Collateralized	Noncollateralized	Total	Collateralized/Total	Collateralized	Noncollateralized	Total	Collateralized/Total
	(In millions of U.S. dollars)			(In percent)	(In millions of U.S. dollars)			(In percent)
Algeria						3,253	3,253	0
Angola						455	455	0
Argentina	350	50,155	50,505	1		676	676	0
Bahrain						2,434	2,434	0
Brazil	400	34,448	34,848	1	203	2,941	3,144	6
Bulgaria		1,471	1,471	0		13	13	0
Chile		3,279	3,279	0		4,405	4,405	0
China	200	11,730	11,930	2	2,198	10,975	13,173	17
Colombia	172	11,299	11,471	1		3,182	3,182	0
Congo, Republic of	600		600	100				
Costa Rica		1,250	1,250	0				
Croatia		3,166	3,166	0	802	363	1,165	69
Cyprus		1,149	1,149	0		175	175	0
Czech Republic		1,716	1,716	0	24	664	688	3
Dominican Republic		500	500	0				
Ecuador		150	150	0				
Egypt		1,500	1,500	0	435	1,094	1,529	28
El Salvador		1,054	1,054	0		14	14	0
Estonia		141	141	0				
Ethiopia					37	307	344	11
Ghana					291		291	100
Gibraltar		89	89	0				
Grenada		100	100	0				
Guatemala		475	475	0				
Hong Kong SAR		8,060	8,060	0	24	1,754	1,778	1
Hungary		11,123	11,123	0	50	232	282	18
India		1,320	1,320	0	460	3,907	4,368	11
Indonesia		1,200	1,200	0		2,044	2,044	0
Iran, I.R. of					500		500	100
Israel	2,700	2,962	5,662	48		1,104	1,104	0
Jamaica		1,662	1,662	0				
Jordan		231	231	0				
Kazakhstan		1,150	1,150	0	63	43	106	59
Kenya						8	8	0
Korea	367	23,929	24,296	2	1,097	5,163	6,260	18
Kuwait						902	902	0
Kyrgyz Republic						95	95	0
Latvia		418	418	0				
Lebanon		7,738	7,738	0				
Lesotho						14	14	0
Lithuania		1,612	1,612	0				
Malaysia	600	14,529	15,129	4	676	10,470	11,146	6
Malta		455	455	0		157	157	0
Mauritius						216	216	0
Mexico	6,737	33,753	40,490	17		1,088	1,088	0
Morocco		442	442	0		270	270	0
Mozambique						68	68	0
Nauru					159		159	100
Oman						790	790	0
Pakistan						7	7	0
Peru		1,430	1,430	0				
Philippines		11,852	11,852	0	39	3,035	3,074	1
Poland		3,793	3,793	0	218	609	827	26
Qatar		2,400	2,400	0	52	2,148	2,199	2
Romania		1,790	1,790	0	330	454	784	42
Russia		15,774	15,774	0	3,594	876	4,470	80
Saudi Arabia					300	13,306	13,606	2
Senegal					40		40	100
Serbia and Montenegro						765	765	0
Seychelles						40	40	0
Singapore		4,961	4,961	0	297	204	501	59
Slovak Republic		2,910	2,910	0		516	516	0
Slovenia		2,106	2,106	0		150	150	0
South Africa		12,384	12,384	0	105	3,338	3,443	3
Sri Lanka		65	65	0	105	593	698	15
Sudan						65	65	0
Taiwan Province of China		400	400	0	72	87	159	45
Thailand		2,159	2,159	0	1,344	2,161	3,505	38
Trinidad and Tobago		780	780	0				
Tunisia		2,417	2,417	0		464	464	0
Turkey		22,955	22,955	0	289	1,928	2,216	13
United Arab Emirates					177	89	266	67
Uruguay		3,049	3,049	0	20	20	40	51
Uzbekistan						78	78	0
Venezuela	1,800	4,601	6,401	28	800	997	1,797	45
Vietnam					42	128	170	25
Total	13,926	330,082	344,007	4	14,843	91,333	106,177	14

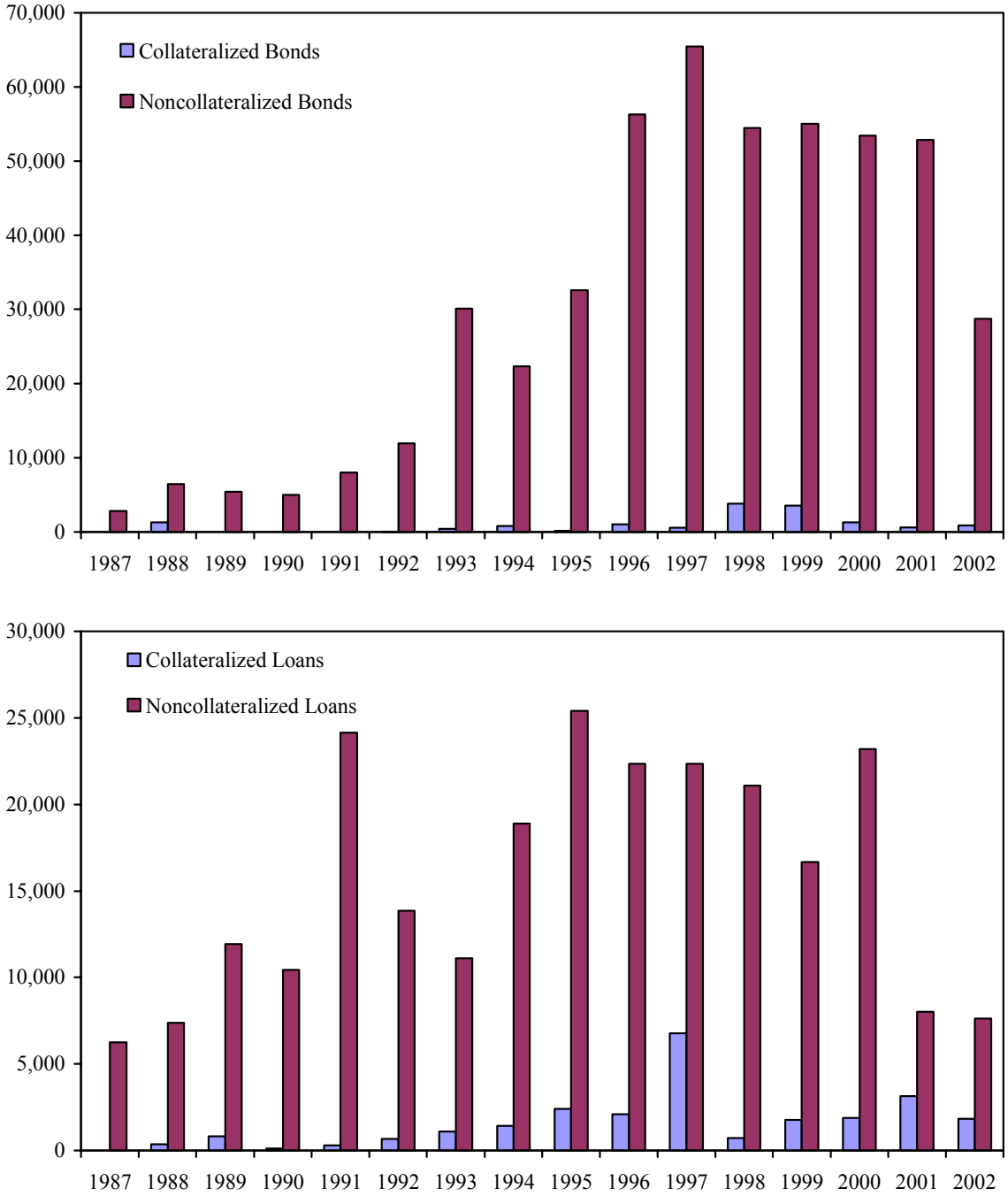
Source: Capital Data.

1/ Bonds and loans issued by sovereigns and public sector enterprises.

2/ Nonmatured issues as of July 1, 2002.

3/ Nonproject financing loans only.

Figure 2. Bonds and Loans Issued Annually by Emerging Markets
(In millions of U.S. dollars at issue, as of July 1, 2002)



Source: Capital Data.
1/ Bonds and loans issued annually by sovereigns and public sector enterprises only.
2/ Loans are nonproject financing and also adjusted for domestic bank and export credit agency participation.

collateralized bonds at $13.9 billion. For bonds, usually only a small fraction of a country's total is collateralized (typically less than 5 percent), with the noteworthy exceptions of the Republic of the Congo (100 percent), Israel (48 percent),[8] Venezuela (28 percent), and Mexico (17 percent). Collateralized loans amount to a more significant part of a country's total loans. In 14 countries, collateralized loans exceeded 25 percent of total, including Ghana (100 percent), Iran (100 percent), Russia (80 percent), and Croatia (69 percent).

18. **Latin American countries have dominated the collateralized bond market** in terms of both the number of issues and the amount of issuance while Southeast Asian countries and Russia have dominated the collateralized loan market. [8]

19. **Oil exporters in 1987 were the first emerging-market countries to use collateralized borrowing.** Non-oil exporters followed three years later. Oil and gas export receivables continue to be the most common form of collateralization. The pattern of issuing collateralized debt over time is particularly uneven for oil exporters. There is a positive correlation between the oil price and the issuance of collateralized debt, possibly because the collateral (oil receipts) becomes more valuable when its price is high.[9]

C. Creditworthiness and Collateralized Borrowing

20. There appears to be some relation between countries' creditworthiness and their collateralized borrowing.

- **"Rich" oil exporters are less prone to use collateralized borrowing than "poor" oil exporters (see Figure 3).**[10]

- **Less creditworthy countries issue more collateralized debt (see Figure 4).** Countries with credit rating BB+ and higher have a smaller portion of collateralized to noncollateralized liabilities than countries with a lower credit rating.

- **Countries tend to issue more/less collateralized borrowing after their credit rating is down/up-graded.** Of the countries examined, collateralized borrowing increased after downgrades in Thailand (1994–2000) and Mexico (1992–99), and declined after upgrades in Malaysia (1992–96) and Brazil (1994–2001).

- **For some countries with low credit ratings, collateralized debt has been the only way to raise external financing** (e.g., Ghana and the Republic of Congo which are HIPC countries).

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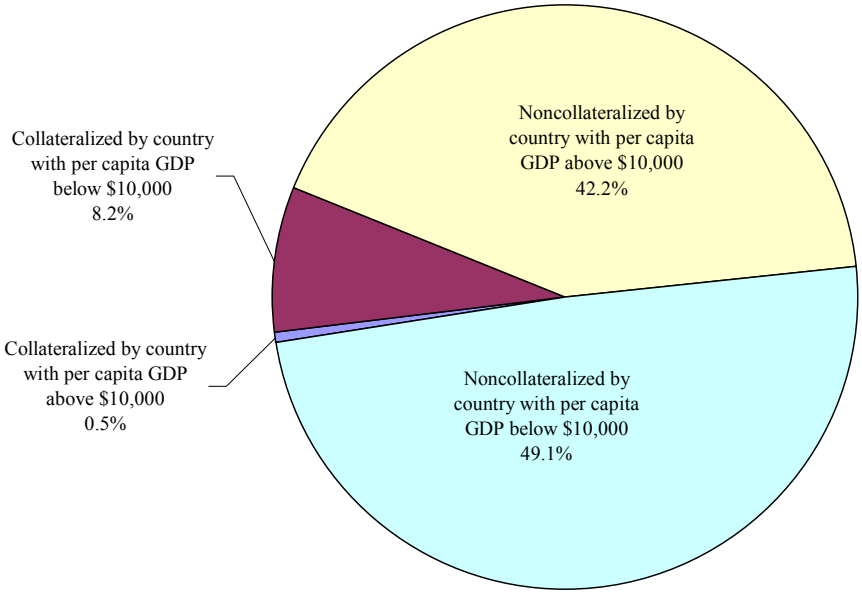
[8] Table 1 records Israel as a country where a significant part of public sector bond issues (in this case by the state-owned electricity company) are collateralized. Unlike in Latin American countries, however, the collateral appears to be fixed assets rather than flow receivables, which are the main focus of this paper.

[9] The more permanent an oil price increase is perceived to be, the greater the impact on the value of the collateral.

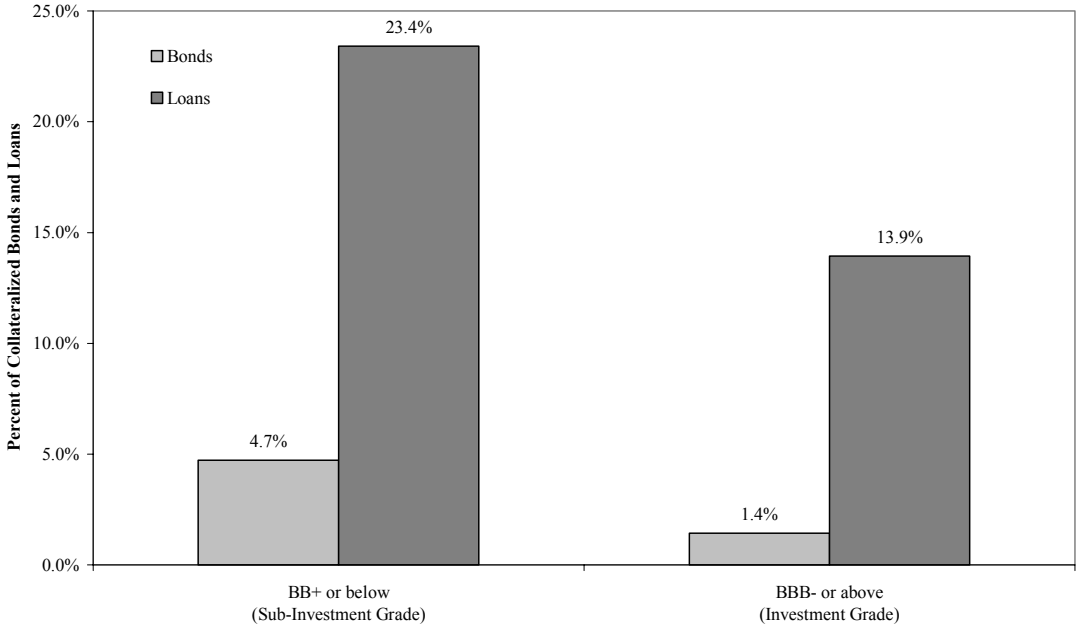
[10] A threshold of $10,000 per capita annual income was set to distinguish rich from poor oil exporters.

Figure 3. Collateralized Borrowing of Oil Exporters by Income Level 1/ 2/ 3/ 4/



Sources: Capital Data, World Bank; and staff estimates.
1/ Bonds and loans issued by sovereigns and public sector enterprises only.
2/ Loans are nonproject financing and also adjusted for domestic bank and export credit agency participation.
3/ Figures are averages over the 1990-99 period. GDP figures are on a PPP basis from World Bank's World Development Indicators data.
4/ Oil-exporting countries included are: Algeria, Angola, Argentina, Bahrain, Cameroon, Colombia, Cote d'Ivoire, Egypt, Indonesia, Iran, Kazakhstan, Kuwait, Lithuania, Mexico, Mozambique, Nigeria, Oman, Papua New Guinea, Qatar, Russia, Saudi Arabia, Sudan, Trinidad & Tobago, Turkmenistan, United Arab Emirates, Venezuela, and Vietnam.

Figure 4. Collateralized Bonds and Loans
as a Share of Total Borrowing of Selected Countries 1/ 2/ 3/
(In percent)



Source: Capital Data and Standard and Poor's.
1/ From 1988 to July 1, 2002, nonmatured bonds and loans issued by sovereigns and public sector enterprises only.
2/ Loans are nonproject financing and also adjusted for domestic bank and export credit agency participation.
3/ Countries selected are: Argentina, Brazil, Bulgaria, Chile, China, Colombia, Croatia, Ecuador, Egypt, Hungary, Indonesia, Korea, Lebanon, Malaysia, Mexico, Morocco, Pakistan, Philippines, Poland, Qatar, Romania, Russia, Slovak Republic, South Africa, Thailand, Turkey, and Venezuela.
4/ Credit Ratings are as of July 1, 2002.

III. Considerations in Assessing Collateralized Future Receipts Arrangements

21. **In theory, it is hard to see why governments or public enterprises would be interested in CFR borrowing**. One could argue that the Modigliani-Miller capital irrelevance theorem, which states that how a company carves up its cash flows into debt or equity should not affect the firm's value, is applicable.[11] As all government debt is implicitly backed by future revenues, dedicating part of these revenues to one type of creditor results in less revenue available for unsecured creditors. Markets would price both types of debt rationally: debt with more dedicated revenue would bear a lower interest rate than debt with less dedicated revenue. As the total amount of revenue has not increased, the government would not reduce its overall average borrowing cost.

22. **What then is the rationale for government CFR arrangements?** Either:

- **the capital irrelevance theorem does not hold in practice** (e.g., CFR arrangements could overcome information asymmetries or institutional restrictions);[12] or

- **governments use CFR borrowing for reasons other than reducing overall borrowing costs,** mainly to enable a government to borrow at all, to borrow more, or to regain market access. Other reasons include to extend debt duration or modify the maturity profile and to make the fiscal or external accounts look artificially healthier.

23. The use of CFR arrangements by the public sector, however, raises a number of important economic policy questions. For presentational purposes, these can be broadly defined as being primarily related to: legal issues, capital market issues, macroeconomic issues and structural fiscal issues.

A. Legal Issues

24. In determining whether CFR arrangements are subject to any legal constraints, an important legal (but not economic[13]) distinction among such arrangements is whether the arrangement gives rise to a claim against the sovereign/public enterprise ("direct" CFR arrangements) or just against an SPV ("indirect" CFR arrangements).

Direct collateralized future receipts arrangements

25. **Direct CFR arrangements may run afoul of negative pledge clauses contained in bond contracts and loan agreements.** These clauses typically preclude borrowers from pledging or encumbering their present or future assets to secure other creditors, without

[11] See Chapter 5 of Hart (1995).
[12] An institutional restriction may be that certain institutional investors are constrained by their investment mandate to only purchase investment-grade debt.
[13] From an economic perspective, the SPV can effectively be seen as part of the public sector.

equally and ratably securing those creditors whose contracts contain the negative pledge clause. The purpose of these clauses is to protect the financial interests of existing creditors. A breach of the negative pledge clause gives rise to an event of default under the terms of the bond or the loan agreement, which may trigger cross-default provisions contained in other debt instruments.

26. **Negative pledge clauses are normally drafted broadly to capture any arrangement with the effect of creating security or giving other creditors a preference over the assets in question, though some leeway may exist.** Negative pledge clauses contained in bond contracts typically only limit the granting of security for debt that shares the same characteristics as the bond where the clauses appear. In the international sovereign bond context, the application of these clauses is generally limited to the collateralization of debt denominated or payable in a foreign currency and only applies to debt in the form of publicly traded securities (i.e., nonnegotiable loans would not be covered).[14] Further, negative pledge clauses normally do not prevent the sovereign from offering assets of public enterprises as security for its own debt. But if the public enterprise in question is an obligor under the terms of the bond, the negative pledge clause would normally preclude that entity from pledging its assets to other creditors. Negative pledge clauses, however, allow the borrower to obtain a commitment by a third party to guarantee new indebtedness, even if the guarantee had to be paid for out of assets of the borrower (e.g., the borrower could issue new debt guaranteed by, say, the World Bank).

27. **Direct CFR borrowings could also be subject to certain constraints imposed by the official sector.** Multilateral development banks could control the amount and type of security that is granted in collateralized borrowings through negative pledge clauses contained in loans extended by them. Unlike those contained in bond contracts and loan agreements, these negative pledge clauses are both broader in scope with regard to the assets they cover and limited in the exceptions they grant to borrowers. For example, the negative pledge clause contained in IBRD loan agreements covers all assets of the borrowing entity, the member country concerned, subdivisions of the member, entities owned or controlled by the member, and entities operating on the member's account or for its benefit (see Appendix I) in the case where a member country is the borrower or guarantor.[15] This clause does not prevent a borrower from providing collateral to secure its other external debt; instead, it ensures that the IBRD's claim will be equally and ratably secured by that collateral so that no other external debt of the borrower will have priority over the IBRD's claim in the

[14] In many cases, negative pledge clauses in bonds include exceptions for liens granted to secure loans used to finance the purchase of the goods in question. In addition, some external bonds also allow for collateral to be given for foreign currency-denominated debt if the debt is only issued domestically.

[15] The negative pledge clause is triggered only if a lien is created on public assets as security for any external debt which will or might result in a priority for the benefit of the creditor in the allocation, realization, or distribution of foreign exchange. See Section 9.03(a) of the General Conditions. In the case where the borrower is not a member country of the IBRD, the negative pledge clause covers all assets of such borrower. See Section 9.03(b) of the General Conditions.

allocation, realization, or distribution of foreign exchange held by or for the benefit of the borrower.

28. **The IBRD negative pledge clause contains two exceptions.** Specifically, it does not apply to: (1) security arising in the course of banking transactions and securing a debt of one year or less; and (2) security consisting of assets that were purchased with the proceeds of financing being secured.[16] In exceptional cases, the IBRD may also grant a waiver in respect of the negative pledge clause at the specific request of the state authorities. In general, for new borrowings, the IBRD has granted waivers only in two circumstances: (1) when the IBRD's exposure in the country, both in absolute terms and relative to other creditors, was *de minimis* and the waiver was not considered to pose any risks to the IBRD as a creditor; and (2) for liens created by government-owned or controlled entities on their own assets and as security for their own borrowings.[17] As the IBRD waiver policy is narrowly defined, waivers have been rarely granted.

29. **The Fund, when determining whether to make its resources available, could decide that the earmarking of resources under collateralized borrowings has reached the point that it effectively undermines the member's capacity to repay the Fund,** even though there is no provision in the Fund's Articles of Agreement that limits the ability of a member to provide collateral as a means of securing its debt. On the basis of that determination, the Fund could conclude under Article V, Section 3, that there are inadequate safeguards for its resources and, therefore, further financing would not be available to the member.

Indirect collateralized future receipts arrangements

30. **In contrast to direct CFR arrangements, indirect CFR arrangements (such as those described in Section II.A) are subject to few legal constraints.** These transactions are often structured in a manner that gives rise to a claim for payment only against the SPV, not the public sector (i.e., not the Originator). As discussed above, from a legal perspective, the arrangement typically involves a "true sale" of future receipts by the Originator to the SPV. After the sale, the future receivables are no longer treated as assets of the Originator, and consequently the holders of the securities issued by the SPV have no claim against, or other relationship, to the Originator. Thus, these transactions do not constitute the creation of security or other type of preferential arrangements by the public sector over specified assets for purposes of any negative pledge clauses and therefore are beyond the

[16] While this latter exception would mean that oil machinery acquired through a loan could be provided as security for the loan in question, the stream of income arising from the sale of the oil extracted through the machinery could not be secured.

[17] Entities must also meet three criteria: (1) the entity was established as a business corporation; (2) the entity was managed autonomously and not included in the government's budget; and (3) the entity's activities had no material financial or economic significance in relation to the ability of the government to service the IBRD loans. Waivers have not normally been given for entities in the main foreign-exchange earning sectors of a country.

coverage of such clauses. However, as discussed above, the SPV can effectively be seen as part of the public sector and the Fund could take into consideration the earmarking of resources implied by CFR borrowings when determining whether to make its resources available to a member. So far, the Fund has never denied resources to a member country on such grounds.

31. *Conclusion: direct CFR borrowings may breach negative pledge clauses in existing debt instruments (in particular, loans extended by multilateral development banks). Indirect CFR borrowings are subject to few legal constraints. However, the Fund could determine that the earmarking of resources implied by direct or indirect CFR borrowings undermines the member's capacity to repay the Fund. On that basis, the Fund could decide that further financing would not be available, although it has never done so in the past.*

B. Capital Market Issues

32. Several characteristics of CFR borrowing may be costly for the borrowing country from a capital market perspective. These include the subordination of unsecured creditors, high transaction costs, and the lack of risk sharing with creditors.

Impact on investors: subordination, reputation, and market access

33. **CFR borrowing de facto subordinates unsecured creditors (both existing and future)** as, everything else being equal, the collateralized creditors have a prior claim on resources that the government could otherwise have used toward meeting the claims of unsecured creditors. The creation of a senior class of debt increases the likelihood that unsecured creditors only, including the Fund, will bear the full cost of the debtor incurring arrears, defaulting, or undertaking an NPV-reducing debt restructuring. By subordinating existing creditors, the country could also gain a reputation for not respecting creditor rights, for example, if existing debt contains negative pledge clauses.

34. **Financial markets may perceive that CFR arrangements are being used only because unsecured financing is not available; the very act of entering into a collateralized deal may itself provide a signal of low creditworthiness.** In particular, collateralization could be perceived by the markets as a means of avoiding market discipline and needed adjustment.[18] This perceived lower discipline could be a source of concern to all creditors, both secured and unsecured. Depending on the reaction of the market, the immediate cost advantages of CFR borrowing may be offset by raising the cost of non-CFR borrowing in the future.

[18] For example, in December 2002, the outgoing Ecuadorian administration announced it would borrow US$245 million collateralized on future oil receipts to finance an expansionary, and possibly unsustainable, fiscal policy. The news was received negatively by the markets, with the Ecuadorian EMBI spread widening about 70 basis points (to 1,803) immediately afterward.

35. **In some cases, however, holders of noncollateralized debt may not view the CFR arrangement negatively.** Such a situation could arise when the government issues CFR debt to obtain the market access necessary to maintain financial stability in the context of an "irrational" and temporary market contagion and otherwise pursues sound economic policies.[19] Because of their relatively high credit ratings, CFR borrowings may also help (re-)establish the country's investor base after a period of absence and build up familiarity and comfort in the issuer. They may also help a country borrow at lower spreads and longer maturity. In such cases, collateralized borrowing could be the bridge for crossing to a good equilibrium of long-term sustainability and a tool for (re)gaining market access for future unsecured issues.

36. *Conclusion: CFR borrowing subordinates unsecured creditors. This, and other possible perceptions that CFR arrangements signal low creditworthiness, may raise future financing costs. Exceptions could include instances when CFR arrangements are targeted at (re-)establishing the government's investor base or when financial markets perceive the borrowing as designed to overcome temporary liquidity constraints.*

Transaction costs and pricing

37. **Although a CFR borrowing may involve lower interest, the overall borrowing costs may be considerable, primarily due to the fixed costs of the transaction.** CFR borrowing typically bears high transaction costs (in the form of legal, banking, and management fees) since most deals are unique and not amenable to standardization.[20] As a result, such deals often require long lead times to put together, making them less useful in times of financial stress. CFR securities also typically occupy a thin market and are traded infrequently. This higher illiquidity (than, for example, plain-vanilla sovereign bond issues) can be expected to be reflected in the financing costs. However, for some collateralized borrowings (such as those based on receivables from oil or gas exports) there is relatively little idiosyncrasy in the structure of the financing which tends to reduce transaction costs and makes the market somewhat more liquid (since there are close substitutes issued by other borrowers). Also, the larger the arrangement, the smaller the impact the fixed costs have on the total cost.

38. **Collateralization may not be an efficient means of borrowing.** As financial markets become increasingly sophisticated, markets routinely analyze credit-enhanced instruments, such as collateralized bonds, by examining their risk components. Moreover, markets often strip the instruments and trade the risk components separately. The transaction costs associated with such strips and the relative illiquidity of the components typically lead markets to value credit-enhanced instruments somewhat below the value of their component parts. In cases where a CFR arrangement is used to reduce the cost of borrowing,

[19] For example, Mexico's use of collateralized Banamex borrowing to initially re-open market access for the sovereign after the 1995 "Tequila" crisis and collateralized PEMEX borrowing after the Russia crisis.
[20] Obtaining accurate information on CFR transactions costs is difficult, but probably lie in the range of 3-4 percent compared to less than 1 percent for a "plain-vanilla" external bond.

consideration should be given to whether the country would be better off issuing plain-vanilla debt and using the cash that would otherwise have been used to back the CFR arrangement to reduce the amount of such borrowing.[21]

39. *Conclusion: CFR borrowing is likely to bear relatively high transactions costs and may be an inefficient use of capital.*

Extent of risk sharing

40. **In practice, CFR arrangements do not usually transfer significant risk to creditors.** In theory, because the repayment of CFR arrangements depends on an uncertain future income stream, significant risk could be transferred from the government to the holders of the CFR obligation. However, CFR arrangements are typically aimed at enhancing creditworthiness and thus governments frequently provide guarantees (e.g., regarding risk of payment, convertibility), allow for supplemental payments once the final value of a sale is determined, or overcollateralize, all signs that not all the risks have not been transferred.

41. **Although CFR arrangements are usually explicitly designed to reduce the risk to the lender of the arrangement compared to noncollateralized borrowing, lenders may still assume some risk related to future revenue.** In some cases, for instance when CFR arrangements include formulas that reduce payments to creditors in cases of price decline, the risk to creditors may be significant. However, in cases where the future receivable transferred to the SPV is subject to a high degree of risk, the government will typically have to pay a high "insurance premium" in the form of overcollateralization which may well be substantial and should be factored into the cost of the borrowing.[22]

42. *Conclusion: CFR arrangements generally do not transfer significant risk to creditors.*

C. Fiscal and Other Macroeconomic Issues

43. A key consideration in determining whether CFR borrowing is appropriate is its macroeconomic impact. The issue is whether CFR borrowing has macroeconomic effects which are different from those associated with noncollateralized borrowing.

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[21] This is one of a number of considerations that led the World Bank to suspend any policy-based guarantee operations covering a portion of debt service on eligible sovereign borrowings, pending further review. These guarantees were provided on a rolling reinstatable basis. Each time a sovereign made a guaranteed debt-service payment, the World Bank guarantee was rolled forward to cover the next nonguaranteed scheduled payment. See also "Involving the Private Sector in Forestalling and Resolving Crises—Further Considerations," EBS/99/21, Revision 1.

[22] For example, bonds (of about US$19 billion) backed by future tobacco-company settlement payments issued by some U.S. municipalities were reported by the Economist newspaper (January 18, 2003) to bear a significantly higher interest rate than similar bonds (6½-7 percent versus 5 percent usually) mainly because investors feared that tobacco companies may not be able to meet their obligations from the 1998 settlement reached with state governments.

Impact on the size of the fiscal deficit

44. **CFR borrowing, by enabling financing that would otherwise not be available, may allow a government to run a higher deficit (and borrow more) than it would otherwise have done.** This higher deficit should be assessed on the basis of its macroeconomic implications, namely, whether the higher debt and deficit are sustainable and the quality of the composition of the higher deficit, for example, whether the higher spending is for productive investment. As a rule, the use of CFR borrowing to evade financing limits weakens the link between the sustainability of fiscal policy and the availability of financing. The critical question is whether the post-borrowing fiscal position is consistent with sustainability or whether the government is using the collateralized borrowing as a means to "overborrow" and to postpone needed adjustment.

45. **Of particular importance is the debt overhang that can result from the boom-bust cycles of commodity prices.** As described in Section II, commodity-producing developing countries tend to increase their borrowing when commodity prices, and thus the value of collateral, is high. A subsequent fall in prices could leave countries with a substantial amount of inflexible debt and a much-reduced flow of resources to service it.[23]

46. *Conclusion: CFR borrowing is likely to be inappropriate if there are concerns about the sustainability of fiscal policy, and if it is used to delay needed adjustment.*

Impact on the quality of financing a given fiscal deficit

47. **For a given fiscal deficit, CFR borrowing would replace an alternative source of financing: the issue then is which is the better source.** From a macroeconomic perspective, the main concerns are the cost of the CFR borrowing and its terms compared to the alternative.

- Collateralized borrowing can be expected to bear a lower interest cost than other forms of borrowing due to the credit enhancement of the collateral.[24] **However, the cost of collateralized borrowing should not be assessed just on the interest rate attached to the specific arrangement but also on the impact on the cost of future borrowing and on the cost of the overcollateralization to the government.** While there are theoretical reasons to expect collateralized borrowing to raise the cost of

[23] A similar situation could arise when oil revenues are shared with lower levels of government (e.g., provinces). For example, the central government could borrow against the future oil revenue of all government levels and be obliged in the future not only to repay this debt but also to make payments to lower levels of government for their share of the forgone oil revenue.

[24] Assessing whether a specific CFR borrowing bears a lower cost or has longer maturity than noncollateralized borrowing is difficult. A thorough assessment requires estimating the terms of a counterfactual non-collateralized borrowing. Ketkar and Ratha (2001) attempted this for collateralized PEMEX arrangements carried out in late 1998 and early 2000. They estimated that the spread reduction was at least 50 bps (from an uncollateralized spread of about 400 bps).

future financing, whether it does so depends on the specific nature and context of the arrangement, aspects of which are discussed above.

- **Consideration should be given to what alternative sources of financing are available.** If long-term, low-cost, "plain-vanilla" alternative sources of financing exist, then the collateralized borrowing is more difficult to justify. If, however, the alternative is borrowing at very short maturity and at high cost, or even running arrears/defaulting, the case for collateralized borrowing is stronger. This is especially so if the country's deficit and debt levels are low and its financing problems are likely to be temporary.

48. *Conclusion: CFR borrowing is likely to be inappropriate if its total cost is higher than plain-vanilla financing or if it significantly increases the cost of future noncollateralized borrowing; it is more likely to be appropriate if few financing alternatives exist.*

Other macroeconomic issues

49. **CFR borrowing arrangements make a country's debt service schedule more inflexible.** Combined with debt from other secured creditors, they reduce a country's room to maneuver in cases of debt or balance of payments crises. As collateralized debt takes priority over uncollateralized debt, the likelihood of foreign-currency payment arrears to junior creditors increases in the event of payment difficulties. In cases where debt service reduction is needed, junior creditors would be asked to increase their contribution (haircut) to restore a country's medium-term viability. This restriction on debt management imposed by CFR arrangements creates problems in other areas, including fiscal flexibility, and in obtaining debt relief in the context of enhanced HIPC relief (discussed below).[25]

50. **This special difficulty of restructuring CFR debt as part of a comprehensive debt restructuring runs counter to the goal of increased private sector involvement in resolving financial crises.** While certain structures, for example, the provincial Argentine bonds collateralized on future coparticipation revenues (see Box 1), could be restructured as they remain onshore, most CFR arrangements are explicitly designed to remove this possibility, for example, by putting the future flows entirely offshore and under a foreign jurisdiction.[26]

51. **In periods of stress in the balance of payments, CFR borrowing could provide a country with immediate financing relief, but at the risk of narrowing room for maneuver in the future.** In some cases, the breathing space provided by such financing

[25] CFR borrowing, by potentially undermining the sustainability of noncollateralized debt, could compromise the domestic financial system, particularly when government debt constitutes a substantial part of banks' portfolio.

[26] Pakistan is a case in point. In 1997, the Pakistan Telecommunications Company issued US$250 million in bonds backed by future telephone settlement receivables from foreign telecommunications companies (the arrangement was all offshore). The bond was excluded from the restructuring of Pakistan's external debt with the London and Paris Clubs in 1999.

could allow policies to take hold, confidence to be restored, and medium-term sustainability to be regained. In other cases, however, the scale of pledging could narrow the authorities' future policy choices, particularly exchange rate policy, as important future foreign-exchange earnings are foregone. Because CFR arrangements are heavily overcollateralized, they immobilize a disproportionate share of (typically scarce) foreign-exchange reserves.

52. *Conclusions: CFR borrowing is likely to be inappropriate if it substantially impairs the government's ability to meet or reschedule its liabilities. While CFR borrowing could help ease immediate calls on official reserves, it does so at the cost of reducing the future flow of official reserves.*

Box 1. Subnational Government Collateralization of Future Revenue— The Case of Tucuman Province, Argentina

In the late 1990s, many Argentine provinces issued collateralized bonds. While some provinces (e.g., Tierra del Fuego) issued debt collateralized on standard receivables (oil and gas revenues), other provinces issued debt collateralized on future coparticipation revenues (a pool of shared tax revenues that the federal government collects and remits to the provinces). Tucuman was one such province.

In August 1997, Tucuman province raised $200 million by issuing a bond collateralized on its future coparticipation revenues. The bond matures in August 2004 and bears a fixed quarterly coupon of 9.5 percent. Tucuman province pledged 35 percent of its aggregate coparticipation revenue on a monthly basis as collateral. The mechanics of the collateralization were: daily transfer of coparticipation revenue by Banco Nacion (which administers the coparticipation revenues on behalf of the federal government) to a custody account in an Argentine bank assigned as collection agent; weekly exchange into U.S. dollars and transfer of pledged revenues to a New York-based trustee; scheduled debt service payments made by the U.S. trustee; a covenant preventing the province from issuing a new and senior pledge on coparticipation revenues; and overcollateralization of cash flows.

The rating agency Fitch IBCA assigned the bond at issue a rating of BB-, just below that of the sovereign. In explaining the rating, the agency said the collateralization was a 'major credit strength' that could lower borrowing costs and lengthen the maturity structure of provincial debt. However, the agency pointed out that the bonds were not issuer remote: the flows were not entirely outside Argentine jurisdiction; the bond lacked a sovereign guarantee; the province could alter the terms of its obligations by declaring an economic emergency; and the agreement contained a cross-default provision that requires acceleration of the bond in the event of a default on any unsecured provincial debt obligation (for which the coparticipation revenues would likely not be sufficient). Indeed, the coparticipation system was altered in December 2000, with the coparticipation transfers replaced with a single, fixed, transfer from the center to the provinces.

The collateralization proved no shelter from the economic storm that engulfed Argentina. Soon after Argentina's default on its external debt payment obligation, Fitch IBCA rated the bond 'D'—default with a poor recovery potential. Fitch IBCA explained the downgrade by the fact that the over-collateralization and cash reserve funds were not protected from the risks of diversion, devaluation, and restructuring. The bond's price has also fallen precipitously. While the bond is highly illiquid, it was being bid in mid-April 2003 at a discount of about 60 percent from its issue price. In contrast, Argentine provincial bonds backed by offshore oil proceeds have so far largely not been substantially affected by the crisis.

D. Fiscal Structural Issues

53. CFR borrowing also has implications for structural aspects of public sector financing relating to: (1) a reduction in fiscal flexibility; (2) governance and transparency; (3) which part of the public sector borrows and for what purpose; and crucially, (4) the relative weight of encumbered assets in the budget.

Reducing future fiscal flexibility

54. **Assigning a future stream of revenue to service collateralized debt amounts to an earmarking operation and reduces future fiscal flexibility.**[27] By limiting the resources under the control of the budget, earmarking constrains the budget's ability to adjust to changing priorities and circumstances. In the specific case of CFR borrowing, a particular concern (in addition to the problem of an inflexible debt service schedule discussed above) is that the related escrow accounts can lock in cash that would otherwise be available to the government. These idle cash balances represent an inefficient use of resources because they could be used for other purposes, for example, reducing short-term borrowing costs. The government could find itself in the position of building up cash balances in the SPV, while simultaneously borrowing at high interest rates or running arrears. Further, if a certain government revenue item (e.g., social security contributions or revenue shared with the provinces) is used as collateral, the government's ability to alter the structure of that item (e.g., to reduce social security contribution rates or to alter the terms of revenue-sharing agreements) may also be constrained.

55. **The example of Tucuman province of Argentina (Box 1) highlights the risk that CFR arrangements may make changing revenue-sharing agreements with subnational governments more difficult, narrowing the government's scope for macroeconomic control.** The collateralized bonds issued by Tucuman province had provisions that constrained the province's ability to change the terms of its coparticipation structure with the central government while abiding by the terms of the CFR arrangement and thus probably contributed to the province's reluctance to renegotiate the coparticipation structure.

56. *Conclusion: Collateralized borrowing is likely to constrain future fiscal flexibility and lead to inefficient cash management.*

Governance, transparency, and accounting

57. **The high degree of complexity and individuality of CFR arrangements may damage transparency and governance.** For example, CFR arrangements are usually difficult to value on a comparative basis with standard debt issues. In addition to the valuation of the new instrument, complex and nontransparent contracts could raise concerns about the value of the collateral and whether it is fairly priced. The lack of transparency may make it difficult for the government to properly price the risk-return trade-off associated with

[27] By allowing a higher fiscal deficit, CFR borrowing can be argued to increase fiscal flexibility in the short run.

this more complicated financing arrangement, resulting in excess profits for the intermediary putting together the arrangement. As a result, particularly where governance issues are a problem, there is more scope for collusion between government agents and lenders that results in a higher risk-adjusted cost of financing than otherwise warranted.[28] Further, cash balances built up from reassigned revenue and held in special accounts are difficult to monitor reliably as is any overpayment.

58. **CFR arrangements may be used to make the fiscal (and external debt[29]) position look artificially healthier.** Most notably, the government may record the proceeds of the CFR arrangement as revenue (or otherwise deficit reducing), on the basis that it represents the sale of an asset, rather than government borrowing. This would improve the overall balance and reduce the recorded amount of government debt (see Box 2). As the potential types and amounts of government receivables that could be collateralized are legion, CFR borrowing has the potential of allowing governments to report deficit and debt levels that do not reflect economic reality. This provoked Eurostat's decision in July 2002 that defined government CFR arrangements to be, in general, borrowing rather than revenue, on the basis that the full risks and rewards (and thus ownership) are not transferred. The 2001 Government Finance Statistics Manual takes a similar position.[30]

59. *Conclusions: CFR borrowing may give rise to governance concerns and obscure transparency. Proceeds from CFR arrangements should generally be treated as government borrowing (not revenue) and presented accordingly in Fund statistics.*

[28] CFR bonds may be more transparent than CFR loans as the terms and conditions of CFR bonds may be more likely to be publicly available.

[29] For example, official Mexican external debt data do not include Eurobonds issued by PEMEX Finance (as the issuer is not a resident of Mexico). PEMEX Finance is the offshore SPV that PEMEX has used for substantial borrowing collateralized on its future export receipts.

[30] A draft Government Finance Statistics Manual (2001) guidance note on the topic defines an economic sale of an asset only when simultaneously: (1) an asset pre-exists on the government's balance sheet; (2) the sale/transaction value is close to the market value; and (3) no material guarantee has been granted by the originator. When one of the criteria is not met, no sale occurred in an economic sense, even though legally a sale may have been completed. Thus while it is possible to conceive of a CFR arrangement that would not be classified as borrowing (for example, the sale of receivables of already-accrued taxes to a collecting company, without recourse to the government), typically, CFR arrangements would be classified as borrowing.

Box 2. Eurostat and the Italian Government's Borrowing Against Future Lottery Receipts

In December 2001, Italy raised € 3 billion by issuing, via a Special Purpose Vehicle, debt collateralized on future receivables generated by two national lotteries. The issue was split into one-, two-, and three-year tranches, each of € 1 billion, priced at six-month Euribor plus 16 bps, 21 bps, and 27 bps, respectively. This issuance was the second such securitization of lottery receipts; the Greek government did the first in December 2000. Unlike the Greek arrangement, the Italian government did not guarantee the debt.

Although the bonds were rated AAA (above the Italian government's rating of AA), the bond's poor liquidity and lack of a government guarantee led to the debt being more expensive than standard Italian government debt. While a direct comparison is not possible, the bond can be compared to the previous Italian government floating rate note that was issued in December 2000 with a maturity of two years and a coupon of Euribor minus 13 bps. Thus compared to issuing regular government debt, the lottery arrangement may have cost some € 20 million over the life of the bonds.

This collateralized borrowing arrangement enabled the Italian government to initially report both a lower debt stock and a lower deficit. The government included the proceeds from the borrowing as an above-the-line operation that reduced the general government deficit. And because the debt issued was not classified as government debt (on the basis that it was not issued or guaranteed by the government), the operation reduced the government's debt stock.

In July 2002, Eurostat decided that the proceeds from collateralizing future receipts not attached to a pre-existing asset should be treated as government borrowing. The decision argued that assigning specific future receipts to an SPV does not constitute a sale of an asset, as the SPV has no control on the generation of receipts unlike the case where it has full ownership of an asset, and thus the proceeds from such arrangements should be considered as government borrowing (to be repaid by the future receipts). This ruling led to an upward revision of Italy's 2001 deficit and debt stocks.

Collateralized borrowing by public enterprises

60. **In general, if a public enterprise's CFR borrowing is to finance its own operations and the enterprise is operating on a wholly market basis,[31] the borrowing should be considered a purely commercial transaction.** Even in this case, however, if the repayment is guaranteed by the government, or the creditor would have recourse to government assets, the arrangement generates a contingent government liability.

61. **When public enterprises on-lend the proceeds of collateralized borrowing to the government, the CFR arrangement should be considered as government borrowing for policy purposes.**[32] In effect, the government is using the public enterprise in this case as

[31] As a rule of thumb, public enterprises would not be operating on a wholly market basis when government: taxes or subsidizes through them; crowds out the private sector through them (notably by paying above-market interest or wages); and accumulates debt (e.g., via government guarantees) or lends through them. It could be further argued that if government retains the possibility of doing so, the enterprise should not be treated as operating wholly on a market basis.

[32] For example, in 1998, the Venezuelan oil company, PDVSA, financed nearly four-fifths of the public sector deficit, largely by borrowing abroad. This was official policy, since PDVSA had a better credit rating than the national government. However, as creditors began to assess the deleterious impact on PDVSA's balance sheet, PDVSA's ratings were downgraded.

a vehicle for its own borrowing. The government could also achieve a transfer of the funds by procedures less transparent than on-lending, such as requiring large profit transfers or raising the tax on the product produced by the public enterprise.

62. **CFR borrowing by public enterprises could be problematic due to the inflexibility of such arrangements.** For example, a public enterprise that cannot reschedule its liabilities may be more likely to require a government bailout than one that can. And in the event of the enterprise's bankruptcy, the government would probably recover less value as the claim of the collateralized creditor would be more difficult to reduce.

63. *Conclusion: CFR borrowing by public enterprises operating on a wholly market basis should generally be viewed as a commercial operation. However, if the proceeds are on-lent to, or guaranteed by, the government or otherwise constitute a contingent government liability, the CFR arrangement should be assessed by the criteria (for government CFR borrowing) discussed above.*

Collateralized borrowing and privatization

64. **CFR arrangements can be likened to privatization and the question is asked: if privatization is good, why are CFR transactions bad?**

- **CFR arrangements fall short of privatization.** CFR transactions do not typically involve the transfer of operational control of the entity generating the future receipts to the private sector. Without such a transfer, the efficiency gains from privatization are unlikely to be realized.

- **CFR arrangements may be used to evade legal restrictions on privatization.**

65. **In fact, collateralized borrowing by public enterprises could hinder their privatization.** By relieving financing constraints, CFR borrowing could allow loss-making activities to continue and may delay privatization. Moreover, public enterprises with excessive collateralized liabilities may also be less attractive to international investors. While in principle the liabilities of a company, including claims by senior creditors, would be reflected in the price of privatization, a low selling price may make the divestiture of state assets politically difficult.

66. *Conclusion: CFR transactions might be designed to effect "back-door" privatizations, but it is doubtful that the full benefits of privatization would be realized or that the government should be trying to evade legal restrictions. CFR borrowings by enterprises may also hinder their eventual outright sale.*

Size of collateralized debt

67. **The size of the collateralized debt relative to the total debt of the sovereign will usually influence the severity of the problems listed above.** A small collateralized borrowing transaction that adds marginally to a low share of collateralized debt in total

government debt is not likely to be viewed as a significant subordination by existing or future unsecured creditors. Nor will fiscal flexibility be significantly impaired by a relatively small stock of collateralized debt. And while the inability to restructure a small collateralized debt may raise issues such as inter-creditor equity, it is unlikely to threaten the government's solvency. Transaction costs, the implications for transparency, and the scope for governance problems are also likely to be minor for a small collateralized transaction. Conversely, when the collateralized transaction and the stock of collateralized debt are very large, these problems are likely to become substantial.

68. *Conclusion: Negative aspects of a collateralized borrowing transaction are likely to depend on the size of the transaction and the stock of such debt.*

IV. Program Design and Procedural Issues

69. The Fund has generally advised against using CFR debt structures (especially for budgetary financing), for the reasons discussed above. However, the Fund has examined the merits of each collateralized borrowing proposal on a case-by-case basis, taking into account financing needs, market access considerations, and future debt service, including capacity to repay the Fund. In addition, there are a number of program-design and procedural issues that need to be considered in formulating a staff view on the advisability of a CFR arrangement.

Treatment of collateralized borrowings under Fund-supported programs[33]

70. **CFR transactions, given their potentially significant macroeconomic implications, will have implications for Fund-supported programs.** Fund-supported programs typically incorporate conditionality on debt accumulation which implicitly encompasses collateralized debt.[34] Beyond this general concern, CFR borrowing may be particularly of concern in certain countries (as illustrated in Box 3), arguing for specific conditionality where it is deemed to be relevant from a macroeconomic perspective.

71. *Conclusion: Where CFR borrowings specifically pose a macroeconomic threat or raise concerns about a member's capacity to repay, separate ceilings should be considered on the contracting of collateralized public debt.*

72. **In PRGF arrangements, collateralized debt would also be subject to the debt ceiling on contracting or guaranteeing new nonconcessional external debt.**[35] In most PRGF-supported programs, this ceiling is set to zero. However, staff has on occasion accommodated borrowing on nonconcessional terms in a Fund-supported arrangement when concessional financing for major developmental projects was not sufficiently available, or when a country was about to graduate from IDA-only status.

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[33] Although outside the scope of this paper, which only focuses on pledges of future flows, of particular concern is the use of reserve assets (e.g., gold or liquid reserve deposits of the central bank) as collateral to obtain new debt. It is standard practice in Fund programs for reserve assets pledged as collateral or encumbered in any way to be excluded from the official reserves definition.

[34] See "The Use of Limits on External Debt in Fund Arrangements," EBS/88/51, March 2, 1988, and "Limits on External Debt or Borrowing in Fund Arrangements—Proposed Changes in Coverage of Debt Limits," EBS/00/128, June 30, 2000. A forthcoming Board paper on "Debt Limits PCs—Best Practices" would revisit the present guidelines on setting debt limits.

[35] Collateralized borrowing is almost always nonconcessional. According to the definition used by the Fund, a loan is concessional if its grant element is at least 35 percent, calculated based on a formula that uses a discount rate based on the average of the OECD's Commercial Interest Reference Rates (CIRR). Most collateralized debt bears an interest of LIBOR plus a margin, which will normally be higher than the relevant CIRR rate plus a margin and thus is nonconcessional unless complemented by very generous grace periods.

Box 3. Fund Advice on Sovereign and Public Enterprise Collateralized Borrowing in Selected Countries

Zambia 1985. In program discussions at a time that Zambia had overdue financial obligations to the Fund, the authorities proposed to raise new financing through borrowing secured on future copper export receivables. *Staff explained that this would not be consistent with the program, and the authorities decided not to proceed with the loan.*

Mexico 1995. In February 1995, Mexico entered into an agreement with the U.S. government to borrow up to $20 billion, as part of the international rescue package following the Peso crisis. Earlier in the month the Fund had approved an SBA of $17.8 billion. The loan agreement with the United States specified that proceeds from oil exports should be channeled through an account at the Federal Reserve Bank of New York, to be used to pay the U.S. government should Mexico fall behind in its debt service. *This arrangement was not opposed by the Fund, because: (1) the finance was essential to the success of the program, and could not have been obtained without the oil proceeds agreement; (2) the finance was from a Fund member country's government, not the private sector; and (3) the arrangement did not involve the irrevocable assignment of export proceeds to an offshore SPV.*

PEMEX 1999. The state-owned Mexican oil and gas company issued $1.5 billion of debt secured by future oil export receivables in July 1999, shortly after the start of a new SBA program. This followed issuance of $2.5 billion of similarly secured debt in late 1998 and early 1999. In the program documentation, Fund staff noted the issues raised by this collateralized borrowing, and a number of Executive Directors voiced their concerns during the Board discussion. However, *on balance the Fund acquiesced to the operations, taking into account:* (1) *the amount concerned was small relative to Mexico's total foreign borrowing, at less than 5 percent, and did not unduly compromise the flexibility of future debt service; and (2) the staff's understanding that the cash resources raised would be used by PEMEX in connection with project finance.*

Ecuador 2000. In negotiations for the April 2000 program, the authorities proposed to raise private sector finance through borrowing secured on future oil export receivables. *Fund staff explained that any collateralized financing would not count toward the program target for new private financing, and this position was reflected in the wording of the memorandum of economic policies. The authorities did not proceed with the borrowing until the prospect of a Fund arrangement had disappeared, the President's term was ending and the government was struggling to finance an excessively expansionary fiscal policy. At that point in December 2002, the government announced it would borrow US$245 million backed by future oil receipts. In view of the Fund's position and the negative market reaction to the proposed scheme, the authorities did not proceed with the borrowing.*

Argentina 2002. *The April briefing paper for a potential SBA included the following prior action: "prohibit provinces from pledging transfers as collateral."*

Lebanon 2002. At the time of the 2002 Article IV discussions, the authorities had begun considering setting up SPVs to securitize excise revenue from tobacco imports and the revenue from the share they might maintain in the cellular phone networks after privatization. *The staff appraisal noted that while this policy would, in the short run, relieve liquidity constraints, it would also affect adversely budgetary revenue and, possibly, government borrowing costs. The authorities were therefore encouraged to reconsider this policy. No transactions have yet been finalized and the authorities have indicated that they would only go ahead after careful scrutiny.*

73. **Under the enhanced HIPC initiative, collateralized debt is included in the debt stock eligible for debt relief as long as it is medium- and long-term public or publicly guaranteed debt contracted and disbursed prior to the end of the relevant base year.**[36] To the extent it is included, it will raise the amount of assistance that a country is eligible for under the enhanced HIPC initiative. Conversely, the creditor of collateralized debt is expected to deliver its full share of debt relief required under the initiative.[37] Practically, however, implementation is difficult as collateralized debt, at least in law, is more senior than noncollateralized debt, including that of multilaterals. The use of negative pledge clauses in other creditors' loan contracts may theoretically bring their claims to the same level of seniority. Enforcement, however, will be difficult if one creditor has physical control over the collateral, or more difficult to justify if it would imply the discontinuation of a development project.

74. **On the other hand, nondelivery of debt relief by individual creditors endangers achieving the HIPC initiative's goal of debt sustainability.** To exclude collateralized debt from the eligible debt stock would require a change in the HIPC methodology, which would be hard to justify as it would violate the principle of equitable burden-sharing.

75. *Conclusion: CFR borrowing will generally not be compatible with PRGF-supported programs. Moreover, the practical difficulty of ensuring that creditors of collateralized debt deliver their full share of debt relief threatens the HIPC's goal of debt sustainability.*

Surveillance

76. **Just as CFR borrowing has implications for Fund-supported programs, it also has implications for Fund surveillance.** While countries that borrow from the Fund may be more likely to engage in CFR transactions for financing reasons, countries without need for the use of Fund resources may engage in such transactions for different reasons, as the case of Italy demonstrates (Box 2).

77. *Conclusion: In countries where public debt sustainability is an issue, Article IV consultations should discuss and collect information on the extent of CFR arrangements.*[38] *Where such borrowing raises particular concerns about a member's current and future fiscal position or the prospects for the balance of payments, the issue should be brought to the Board's attention, by including staff's and the authorities' position in the staff reports.*

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[36] This definition includes external debt of enterprises in which the public sector has a share of more than 50 percent, even if this debt is not explicitly guaranteed by the government.

[37] For an official bilateral creditor, this consists of two steps: debt relief under traditional mechanisms (Naples stock operation), and assistance under the enhanced HIPC initiative as measured by the creditor's share in the NPV of debt after (hypothetical) traditional debt relief in the base year.

[38] Where such arrangements are inappropriately not classified as debt, this should be highlighted as not following best statistical practice.

V. CONCLUSION

78. **The issues raised in previous sections explain why the Fund has generally advised against using CFR debt structures,** especially for budget financing. Potential problems associated with CFR borrowing include: possible breach of negative pledge clauses; constraints on the flexibility of debt management; possible increases in future (and perhaps current) financing costs; excessive debt accumulation and the related erosion of the sustainability and future flexibility of fiscal policy—and in some cases of exchange rate policy; nontransparencies in the borrowing arrangements; and potential hindrances to privatization of public enterprises. In some cases, however, CFR financing could act as a bridge for (re)accessing foreign financing, thus providing breathing space that could allow policies to take hold, confidence to be (re)built and medium-term sustainability to be (re)gained.

79. **Taken together, these factors often add to a case against CFR borrowing.** However, this paper recommends that the Fund continue to examine the merits of each collateralized borrowing proposal on a case-by-case basis, taking into account the concerns above, the size of the borrowing, financing needs, market access considerations, and future debt service, including capacity to repay the Fund. For surveillance cases, this would require more attention to be paid to collecting information on CFR borrowing. For program cases, CFR borrowing may well not be compatible with program goals (especially for PRGF/HIPC-eligible countries), in which case the Fund should withhold financing. In others, specific conditionality might serve to contain the impact.

The IBRD's Negative Pledge Clause
(Section 9.03 of the General Conditions)

Section 9.03. Negative Pledge

(a) It is the policy of the Bank, in making liens to, or with the guarantee of, its members not to seek, in normal circumstances, special security from the member concerned but to ensure that no other external debt shall have priority over its loans in the allocation, realization, or distribution of foreign exchange held under the control or for the benefit of such member.

(i) To that end, if any lien shall be created on any public assets (as hereinafter defined), as security for any external debt, which will or might result in a priority for the benefit of the creditor of such external debt in the allocation, realization, or distribution of foreign exchange, such lien shall, unless the Bank shall otherwise agree, ipso facto and at no cost to the Bank, equally and ratably secure the principal of, and interest and other charges on, the Loan, and the member of the Bank which is the Borrower or Guarantor, in creating or permitting the creation of such lien, shall make express provision to that effect; provided, however, that if for any constitutional or other legal reason such provision cannot be made with respect to any lien created on assets of any of its political or administrative subdivisions, such member shall promptly and at no cost to the Bank secure the principal of, and interest and other charges on, the Loan by an equivalent lien on other public assets satisfactory to the Bank.

(ii) As used in this paragraph, the term "public assets" means assets of such member, of any political or administrative subdivision thereof and of any entity owned or controlled by, or operating for the account or benefit of, such member or any such subdivision, including gold and foreign-exchange assets held by any institution performing the functions of a central bank or exchange stabilization fund, or similar functions, for such member.

(b) The Borrower, which is not a member of the Bank undertakes that, except as the Bank shall otherwise agree:

(i) if such Borrower shall create any lien on any of its assets as security for any debt, such lien will equally and ratably secure the payment of the principal of, and interest and other charges on, the Loan and in the creation of any such lien express provision will be made to that effect, at no cost to the Bank; and

(ii) if any statutory lien shall be created on any assets of such Borrower as security for any debt, such Borrower shall grant at no cost to the Bank, an equivalent lien satisfactory to the Bank to secure the payment of the principal of, and interest and other charges on, the Loan.

(c) The foregoing provisions of this section shall not apply to: (i) any lien created on property, at the time of purchase thereof, solely as security for the payment of the purchase price of such property or as security for the payment of debt incurred for the purpose of financing the purchase of such property; or (ii) any lien arising in the ordinary course of banking transactions and securing a debt maturing not more than one year after the date on which it is originally incurred.

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