INTERNATIONAL MONETARY FUND

The Multilateral Debt Relief Initiative (G-8 Proposal) and Its Implications for the Fund—Further Considerations: Supplement on Financing Arrangements

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(In consultation with other departments)

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I. INTRODUCTION

1. **This supplement discusses the financial structure for the implementation of the G-8 debt relief proposal or Multilateral Debt Relief Initiative (MDRI)**.[1] Implementation of the MDRI will require action by the Executive Board and by contributors to the Subsidy Account of the PRGF Trust. To be in a position to deliver debt relief under the MDRI by the beginning of 2006 will require the early adoption by the Board of a number of decisions. It will also require the timely consent by all contributors to the Subsidy Account of the PRGF Trust to an amendment of the PRGF Trust Instrument that would allow the transfer of a portion of their resources to a new administered account for use in providing MDRI debt relief to HIPCs with incomes above the MDRI threshold.

2. **The financial structure for the MDRI would build on that already existing for the provision of assistance under the HIPC Initiative**. However, the modalities contemplated would entail the reallocation of certain PRGF Trust resources and the accelerated delivery of HIPC debt relief resources. These changes stem from the broader scope of debt relief envisaged under the MDRI and the way in which such relief would be delivered. The next section reviews the main elements of the existing financial structure for the extension of PRGF Trust loans and HIPC Initiative assistance. Section III discusses the nature of the changes needed to adapt this structure to the MDRI as well as several immediate implementation issues.

II. EXISTING FINANCIAL STRUCTURE FOR THE PRGF AND THE HIPC INITIATIVE

A. PRGF Trust

3. **PRGF operations are conducted through three accounts within the PRGF Trust: the Loan Account, Reserve Account, and Subsidy Account**.[2]

- The PRGF Trust borrows from central banks, governments and official institutions through the ***Loan Account***, largely at market-related interest rates, and lends the borrowed resources to PRGF-eligible countries.[3] The Loan Account effectively acts

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[1] See the main paper, *The G-8 Debt Cancellation Proposal and Its Implications for the Fund—Further Considerations* (9/19/05).

[2] See *PRGF Trust Instrument, Sections III, IV and V*. See also *Financial Organization and Operations of the IMF,* Pamphlet No. 45 Sixth Edition, Chapter IV.

[3] There are currently 16 PRGF Trust lenders to whom loans are owed. The loan provided by one lender, the Swiss Confederation, has been fully repaid.

as a pass-through account, drawing on the lenders and disbursing to PRGF-eligible borrowers. Drawings by the PRGF Trust on commitments from individual lenders are made, to the extent possible, to maintain broad proportionality of drawings relative to commitments of individual lenders.

- The ***Reserve Account*** provides security to the lenders to the Loan Account of the Trust, and absorbs temporary mismatches between repayments from borrowers and payments due to lenders. Resources held in the Reserve Account of the PRGF Trust are available to protect the lenders to the Trust against risks arising from overdue principal and interest payments by borrowers, and act as a buffer for payments mismatches. Payments made from the Reserve Account are replenished upon the settlement by the borrower concerned of the payments arrears or mismatches that resulted in disbursements from the Reserve Account.

- Resources held in the ***Subsidy Account*** are used to subsidize the difference between the interest owed to PRGF Trust lenders—whose loans typically earn the six-month SDR interest rate—and the interest rate of ½ percent per annum paid by PRGF borrowers.[4] Subsidy resources are made up of bilateral contributions, including implicit subsidy contributions through loans extended at concessional rates, from 43 contributors and the Fund's own resources from the Special Disbursement Account (SDA) (a one-time transfer in 1994).[5]

B. PRGF-HIPC Trust

4. **The PRGF-HIPC Trust, established in 1997, receives and provides resources for debt relief under the HIPC Initiative and for the subsidization of the interim PRGF**. The PRGF-HIPC Trust is funded through bilateral contributions and resources from the Fund itself, the latter mainly SDA resources in the form of the investment income on the proceeds of the 1999–2000 off-market gold transactions. The operations and transactions of the PRGF-HIPC Trust are conducted through one account, under which three sub-accounts have been established—the PRGF sub-account, the PRGF-HIPC sub-account, and the HIPC sub-account—to permit contributors to earmark resources for either PRGF or HIPC operations or both.

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[4] For a status report on availability of resources in the PRGF accounts, see *Review of PRGF-HIPC Financing, the Adequacy of the Reserve Account of the PRGF Trust, and Subsidization of Emergency Assistance* (9/8/05).

[5] See Box 1 of the main paper.

5. **Debt relief under the HIPC Initiative is channeled through a separate Umbrella Account sub-account established for each HIPC beneficiary to which such relief is provided**. The resources in each sub-account of the Umbrella Account represent HIPC grants approved by the Board and disbursed to the member mainly at the completion point, but also in the form of interim assistance between the decision and completion points, plus accumulated interest. These resources constitute an entitlement for the beneficiaries, but are administered by the Fund, as Trustee of the PRGF-HIPC Trust.[6] They are used to meet each beneficiary's obligations to the Fund as they fall due based on a schedule approved by the Board.

C. The Special Disbursement Account

6. **The SDA serves mainly as the vehicle for receiving and investing profits from the sale of gold held by the Fund on the date of the Second Amendment and for making transfers to other accounts for special purposes authorized under the Articles of Agreement, in particular for financial assistance to low-income members of the Fund.** Currently, the assets of the SDA include the proceeds of gold sales and accumulated interest. Under current decisions, only the investment income generated from the proceeds from the 1999–2000 off-market gold transactions, up to SDR 1.76 billion, is available to finance HIPC debt relief.

III. Financing Arrangements for the MDRI

A. Delivery of Debt Relief

7. **The MDRI can be implemented by providing debt relief resources so as to enable the early repayment of the full stock of eligible debt owed to the Fund by beneficiaries once they qualify for such relief.** As an alternative (and as is currently done under the HIPC Initiative), the MDRI could also be implemented by providing debt relief as a flow of payments to match eligible obligations as they fall due. Under either alternative, the

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[6] HIPC assistance provided at the completion point is irrevocable, and any amounts remaining in a member's Umbrella Account sub-account after the settlement of that member's eligible debt service obligations to the Fund must be transferred to the member (Decision No. 11698-(98/38) ESAF, 4/1/98). In contrast, the Fund may under certain circumstances retransfer to the PRGF-HIPC Trust amounts that have been disbursed into a sub-account as interim assistance (see Section III, paragraphs 3(b) and 3(d) of the PRGF-HIPC Trust Instrument).

costs to the Fund would be equivalent on a net present value basis.[7] However, the early repayment of eligible debt (stock) option would appear more closely aligned with the intention of the initiators of the MDRI and the expectations of beneficiaries. This approach, implemented over a relatively brief period, would also raise fewer accounting and investment issues. In contrast, under a flow approach, resources disbursed for debt relief would be held over a number of years pending their use to meet obligations falling due to the Fund. These resources would need to be held by the Fund and invested on behalf of the beneficiaries during this period, thereby increasing the administrative costs and risks for the Fund associated with the implementation of the MDRI. In addition, the obligations to the Fund subject to debt relief would remain outstanding in the Fund's financial statements. Given these considerations, staff recommends that debt relief under the MDRI be delivered so as to allow the early repayment of the full stock of eligible obligations.

8. **The debtors' obligations to be relieved under the MDRI mainly comprise loans extended by the PRGF Trust,[8]** which in turn were funded by lenders to the PRGF Trust. Staff recommends that the early repayment under the MDRI of debtors' PRGF obligations should generally be accompanied by the early repayment of lenders' outstanding loans to the PRGF Trust. Most of the PRGF Trust borrowing agreements allow for such early repayment by mutual agreement between the Fund and the lender, although this is not required under the borrowing agreements. Since the lenders have provided these loans primarily for the purpose of funding on-lending by the PRGF Trust, their early repayment is a logical extension of the decision to relieve debtors' obligations under the MDRI. This would also avoid the need for the Fund to incur the administrative costs and risks associated with maintaining these obligations. An exception may be needed for those loans that are also intended to provide implicit subsidies, unless an alternative modality could be found for delivering those subsidy resources.

[7] Under the flow approach, the members qualifying for the MDRI would be relieved of future obligations on their eligible debt, but the Fund would need to have sufficient resources to meet the associated future stream of principal and interest payments to PRGF Trust lenders. Cost equivalence of the two approaches is based on the assumption that the interest rate that the Fund earns on these resources would be broadly the same as the rate that it pays to PRGF lenders.

[8] A relatively small amount involves Fund credit from the GRA (see Table 2 of the main paper). Fund credit extended through the GRA would be repaid early once debt stock relief is delivered.

B. Related Modifications

9. **The financing of the MDRI will draw resources from members' Umbrella Account sub-accounts, bilateral PRGF Trust Subsidy contributions, and the SDA**, each of which would, inter alia, require related Board decisions to redirect use of these resources for the MDRI.

10. **Resources in Umbrella Account sub-accounts would be the first source of funds for delivery of the HIPC component of the total debt relief contemplated under the MDRI.** As discussed in the main paper and the companion supplement to this paper, all HIPCs (whether above or below the US$380 income threshold) will receive SDA resources for HIPC Initiative relief. This may be in the form of SDA resources already disbursed to the sub-accounts for the HIPC members that have reached their completion point or received interim assistance, or SDA resources that will be disbursed to the sub-accounts in the future as interim assistance or completion point relief.

11. **In line with the proposal that MDRI relief be delivered so as to permit the early repayment of eligible debt as discussed above, staff also proposes that financial assistance provided under the HIPC Initiative at completion point be delivered in a similar manner**. This would require an amendment of the provisions of the PRGF-HIPC Trust Instrument that govern the delivery of HIPC debt relief. It would also require that the HIPC delivery schedules that have so far been adopted at the completion point be changed, and that future completion point schedules be designed differently. Changes to existing schedules would require the consent of the individual HIPC members that have already reached the completion point, and a country-specific Board decision adopted by a majority of the votes cast to revise each schedule. Interim HIPC assistance for countries between the decision and completion point would continue to be delivered to meet obligations on a flow rather than stock basis, as done under current arrangements. However, when these countries reach the completion point, the delivery schedule for the completion point relief disbursed at that time (plus any remaining interim assistance) would provide for use of the HIPC assistance to repay covered obligations on a stock rather than flow basis.

12. **As explained in the main paper and the companion supplement, the per capita income threshold selected for eligibility under the MDRI affects both the level of debt relief provided under the MDRI and the structure of its financing.** Under the approach set forth in the main paper, bilateral contributions to the Subsidy Account of the PRGF Trust would be used to finance beyond-HIPC debt relief under the MDRI for those HIPCs identified by the G-8 whose per capita income exceeds the threshold. Reallocating bilateral contributions in this way would require an amendment of the terms of the Subsidy Account. This amendment would need to be requested by bilateral contributors, and it would become effective only with the consent of all 43 bilateral contributors.

13. **As also discussed in the main paper, upon request, a separate administered account would be established under Article V, Section 2(b)**, into which Subsidy Account

bilateral contributions could be transferred for use in providing MDRI relief to HIPC members with incomes above the threshold. The Board decision to establish such an account could be adopted by a majority of the votes cast. Separately, additional modalities will also need to be established for the receipt from bilateral contributors of amounts that will be provided to cover costs associated with debt relief to potential sunset clause and protracted arrears countries, and for the delivery of these resources to members.[9]

14. **Bilateral subsidy contributions reallocated for debt relief under the MDRI would need to be at least equivalent to SDR 1.12 billion—the currently estimated cost of providing beyond-HIPC MDRI debt relief to the identified HIPCs that have a per capita income above the US$380 threshold.** The balance in the Subsidy Account at end-2005 is projected to be SDR 1.65 billion, including about SDR 0.24 billion in contributions by the Fund,[10] leaving SDR 1.41 billion in bilateral contributions not subject to uniformity-of-treatment requirements.[11]

15. **Finally, the implementation of the MDRI would require the amendment of existing decisions and the adoption of new decisions governing the use of SDA resources.** These decisions would need to be adopted by an 85 percent majority of the total voting power. Specifically, the Board would need to authorize the use of both the corpus and investment income for the following purposes:[12]

- **Debt relief under the HIPC Initiative for all qualifying countries (i.e., regardless of income levels).** This would include completion point relief (currently estimated at about SDR 0.44 billion, but subject to a high degree of uncertainty) and interim

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[9] As discussed in the companion supplement, the G-8 Finance Ministers stated in their Communiqué of June 16, 2005 that donors were committed to provide the extra resources necessary to give debt relief to the protracted arrears cases and cover the costs arising from the inclusion of countries under the extended sunset clause of the HIPC Initiative.

[10] See Box 1 of the main paper.

[11] All estimates provided in this supplement are in end-2005 NPV terms.

[12] The existing decisions authorizing use of SDA resources for HIPC Initiative assistance relate only to the use of investment income on the corpus of the off-market gold sales (Decision No. 12063-(99/130), 12/8/99, and Decision No. 12330-(00/118), 11/30/00). Since this investment income would be insufficient to cover the provision of upfront assistance to allow early repayment of eligible debt, the corpus of the sales would also need to be authorized for HIPC Initiative assistance.

assistance (estimated at about SDR 0.09 billion) to the 17 identified pre-completion point countries;[13]

- **Beyond-HIPC MDRI relief** for countries with per capita incomes at or below US$380 (estimated at about SDR 1.50 billion); and

- The remaining balance (estimated at about SDR 0.47 billion) could be **transferred to the PRGF Subsidy Account** for the subsidization of existing and future interim PRGF lending operations. This transfer could be effected in steps, with an initial transfer to be undertaken upon the effectiveness of the relevant MDRI decisions.

C. Immediate Implementation Issues

16. **Immediate implementation issues center around the 18 countries that have already reached completion points**. Of these countries, 10 have per capita incomes at or below US$380, with the rest having per capita incomes above this threshold. These countries are estimated to have a stock of credit outstanding to the Fund of SDR 2.26 billion at end-2005. As discussed in the companion supplement, these countries would receive financial assistance to allow the early repayment of all eligible debt to the Fund after the Board adopts the relevant country-specific decisions, which in turn requires the Board to confirm the qualification of each member for such relief. It is estimated that the funding of MDRI debt relief for these countries would be as follows: (i) HIPC Umbrella Account sub-accounts of about SDR 0.31 billion for HIPC Initiative relief; (ii) the SDA of about SDR 1.0 billion for MDRI relief to those of the 18 that have incomes at or below US$380; and (iii) contributor resources transferred from the PRGF Subsidy Account of about SDR 0.96 billion for MDRI relief to those of the 18 that have incomes above the US$380 threshold.

17. **As noted above, proceeds from the early repayment of PRGF Trust loans in the context of debt stock relief under the HIPC Initiative and MDRI could in turn be used to make early repayment to PRGF Trust lenders**. The PRGF Trust Instrument indicates that calls on lenders for loan resources are to be made so as to preserve broad proportionality across lenders but is silent on the issue of pre-payment to lenders. Parallel treatment would argue for proportionality to be applied also to pre-payments. Proportional prepayment of loans to PRGF Trust lenders could be based on projected outstanding balances as of end-December 2005. However, as discussed, an exception may be required with respect to those

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[13] As discussed in the main paper and the companion supplement, these estimates exclude HIPC assistance and MDRI debt relief to sunset clause countries and protracted arrears cases. As also noted in those papers, however, sunset and protracted arrears countries would be eligible to use SDA resources for both HIPC and MDRI relief if they were to otherwise meet the qualification requirements for such relief.

lenders whose borrowing agreements provide for loans at below-market interest rates. As these implicit subsidies are an integral part of the subsidy resources required for the interim PRGF, it would be important to consult and agree with these lenders on arrangements to maintain the implicit subsidy contributions.

IV. Next Steps

18. **In light of the Executive Board discussion of the main paper and the companion supplements, staff will prepare and present the draft decisions needed to implement the MDRI for Board consideration** (as noted above, these decisions would need to be preceded by certain requests from contributors). Staff would then initiate the process of contacting bilateral contributors to the PRGF Subsidy Account to obtain their consents to the amendments of the PRGF Trust Instrument. The MDRI implementing decisions would become effective once the requisite consents had been received. The Board would thereafter adopt the country-specific decisions necessary for the actual delivery of MDRI relief, once it confirms the qualification of particular members for relief.