

Document: EB 2012/107/R.34  
Agenda: 14(e)  
Date: 6 December 2012  
Distribution: Public  
Original: English

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## **Question concerning preferred creditor status and the rescheduling of loans**

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Executive Board — 107<sup>th</sup> Session  
Rome, 12-13 December 2012

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**For: Information**

## Question concerning preferred creditor status and the rescheduling of loans

### I. Introduction

1. As requested by the Republic of the Sudan (hereinafter "the Sudan") and in an effort to help the Sudan cope with its difficult economic situation, IFAD negotiated a rescheduling of debt with the Sudan according to IFAD's policy and rules governing arrears, which was submitted to the 106<sup>th</sup> session of the Executive Board. During the discussions of the Executive Board, certain Board members pointed out that the debt negotiations taking place between the Fund and the Sudan are progressing faster than with other organizations. Two issues were highlighted in this regard. First, the fact that the Fund is a committed participant of the Heavily Indebted Poor Countries (HIPC) Debt Initiative framework under which, typically, development banks are expected to move forward together. Second, the question of whether the Fund is expected to respect the preferred creditor status of the World Bank and the International Monetary Fund (IMF) when considering the rescheduling debt plan.

### II. IFAD Governing Council directives

#### A. Arrears policy

2. At its twenty-first session the Governing Council considered document GC 21/L.7 on "IFAD's Policy Framework for Managing Partnerships with Countries in Arrears" and the draft resolution contained therein and adopted paragraph 32(g) of the IFAD Lending Policies and Criteria in order to establish a framework for managing partnership with countries in arrears. This reads as follows:

*"for the purposes of resolving arrears that may arise from time to time in the payment of interest/service charges and the repayment of the proceeds of loans, the Executive Board may amend the terms upon which an approved loan is provided to a country, including the grace period, the maturity date and the amount of each instalment for the repayment of loans, while securing the original Net Present Value".*

3. In other words, the Governing Council has given the authority and responsibility to the Executive Board to resolve arrears that may arise in the payment of debt service and the repayment of loans by borrowing Member States.
4. It will be recalled that the introduction of this authorization was to enable the Executive Board to effectively deal with the negative consequences of loan arrears for the achievement of the Fund's objectives in relation to countries in need of its assistance. The negative consequences identified by document GC 21/L.7 are:
  - (a) **Suspension of projects and country portfolio.** The most important consequence of arrears is the suspension of loan disbursements. An analysis of suspensions on IFAD loans given at the time indicates the at times irreparable impact of loan suspensions on project momentum, on the commitment of the stakeholders in the field, and in particular on beneficiary participation.
  - (b) **No extension of closing date.** Projects are not eligible for extension of their loan closing dates while they are suspended.
  - (c) **Cofinancing.** There is a risk that the cofinancier may also interrupt its disbursement processes, thereby further depriving the project and the country of the committed external resources.
  - (d) **New project development.** While disbursements for ongoing projects are suspended, new lending is also affected in the following ways: (i) new loans will not be processed or presented to the Executive Board when a country is in

serious arrears; (ii) loans approved by the Executive Board will not be signed if more than marginal arrears exist at the scheduled date of loan signature; and (iii) signed loans will not be declared effective if more than marginal arrears exist when the conditions of effectiveness are met.

5. These comprise the paramount considerations to be kept in mind when exercising the authority given by the Governing Council in paragraph 32(g) of the IFAD Lending Policies and Criteria.

## **B. Participation in the HIPC Initiative**

6. The HIPC Initiative was first launched by the IMF and the World Bank in 1996 and modified in 1999 as an "enhanced" debt initiative to eliminate unsustainable debt in the world's poorest and most heavily indebted countries. HIPC countries must meet certain criteria, commit to poverty reduction through policy changes and demonstrate a good track record over time. Based on an assessment of those criteria, the Executive Boards of the IMF and the World Bank will formally decide on countries' eligibility for debt relief, following a consultation process among all creditors, including the Paris Club and the international financial institutions (IFIs). All participating creditors, by an agreement, commit to reducing the countries' debt to a level that is considered sustainable with the settled burden-sharing of the targeted debt. The foregoing process, which culminates in an agreement, is referred to as the decision point under the HIPC Initiative. Once a country reaches its decision point, it may immediately begin receiving interim relief on its debt service falling due.
7. As the fifth largest provider of HIPC debt relief to Africa, the Fund has been a committed participant in the HIPC process since its inception. The Executive Board endorsed the principle of the Fund's engagement in the original HIPC Debt Initiative at its fifty-ninth session in December 1996 as an element of the Fund's broader policy framework for managing operational partnerships with countries that are in arrears with the Fund. The Governing Council, at its twentieth session in February 1997, by resolution 101/XX, amended paragraph 32 of the Lending Policies and Criteria by adding the text below, which delegates approval authority to the Executive Board:
 

*"For the purposes of implementing the Heavily-Indebted Poor Countries Debt Initiative, the Executive Board may amend the terms upon which an approved loan is provided to a country. In determining the grace period, the maturity date and the amount of each instalment for the repayment of loans, the Executive Board shall take into account an assessment of a country's debt sustainability produced under the Heavily-Indebted Poor Countries Debt Initiative."*
8. On the basis of document GC 21/L.6, the Governing Council at its twenty-first session adopted the operational policy framework for IFAD's participation in the HIPC Initiative by resolution 105/XXI and authorized the establishment of IFAD HIPC Debt Initiative Trust Fund for the purpose of carrying out debt relief operations. The Governing Council subsequently decided at its twenty-third session in February 2000 by resolution 117/XXIII, that IFAD would fully participate in the enhanced debt initiative. This mechanism is now operational.
9. As provided by paragraph 6 of Governing Council resolution 105/XXI (1998), "the IFAD HIPC DI Trust Fund shall be used to reduce the debt burden of Member States declared eligible under the HIPC DI to a sustainable level ...". This implies that as long as a country is not a declared eligible HIPC country, the norms and procedures of HIPC framework, including operating in a coordinated fashion with all participating creditors do not apply and that consequently, the Fund is compelled to settle the issue of its borrowers arrears in accordance with its own policy and rules on the arrears issue.

### **III. Perspectives of the International Bank for Reconstruction and Development and the International Monetary Fund**

10. The Office of the General Counsel approached the Legal Vice Presidency of the International Bank for Reconstruction and Development (IBRD) and the Legal Department of the IMF to establish whether, under the HIPC Initiative, the Fund can do so unilaterally or whether IFAD would have to wait for the World Bank and the IMF to proceed with arrears clearance. The ensuing question is whether, if the Fund goes ahead with the concessional rescheduling prior to a country's decision point, it would be considered as part of the Fund's debt relief to such a country under HIPC. In answer to the Office of the General Counsel's question whether, and if so, at what point in time there is a requirement or expectation under the HIPC that multilateral financial institutions move forward together and cease unilateral enforcement of financing agreements, the Legal Vice Presidency of the IBRD and the Legal Department of the IMF informed as follows:
- In order for a country to receive HIPC debt relief, a number of key issues will have to be resolved. These include (i) a normalization of its relations with creditors, including through clearance of arrears to the multilateral creditors, and (ii) securing the necessary resources for its creditors to finance their share of the cost of HIPC debt relief. Qualification for relief will be subject, in particular, to confirmation that debt sustainability indicators are above the relevant HIPC thresholds and assurances from creditors that they are ready to provide such relief.
  - Participation by creditors in the HIPC Initiative is voluntary, and therefore there is no requirement of coordinated action by all of a country's creditors. However, a key principle underlying the HIPC Initiative is that there is an expectation that action should be coordinated among all creditors involved, with broad and equitable participation, recognizing that the success of the HIPC Initiative in allowing an exit from an unsustainable debt burden depends on the comprehensive participation of all creditors. The longstanding approach regarding arrears clearance and debt relief consists of adopting a comprehensive framework in the context of solidarity among creditors.
  - When the key issues related to a country's qualification for debt relief are resolved, the IBRD and the IMF would probably then move forward to realize the expectation of coordinated action referred to in the second bullet point above. Under the HIPC Initiative, the IMF and the IBRD commit at the decision point (i.e. the point at which the Fund decides whether a member qualifies for assistance under the Initiative and on the amount of assistance), to provide their respective shares of debt relief conditional on satisfactory assurances of commensurate actions by other creditors. To the extent, therefore, that a creditor were to provide assurances, there would be an expectation that this creditor would provide the committed assistance. Debt relief would then be provided by creditors at the completion point (i.e. the point when the Fund takes a decision to disburse assistance committed for the qualifying member).
  - Under the HIPC Initiative, a rescheduling on concessional terms prior to the decision point can be counted towards a multilateral's share of HIPC debt relief. We can confirm that in cases where multilateral creditors grant a concessional restructuring of arrears prior to HIPC decision point, the concessional element embedded in the restructuring can be counted as part of the creditor's share of HIPC debt relief. The practice of counting the grant element of arrears clearance operations has been applied systematically since its adoption in 1998 (as evidenced in the relevant HIPC country documents).

#### **IV. Ranking of IFAD's repayment claims in relation to those of other IFIs**

11. As noted above, participation by creditors in the HIPC Initiative is voluntary, and therefore there is no requirement of coordinated action by all of a country's creditors. Thus in the absence of a decision of the Governing Council to give way to claims of other multilateral creditors on the Fund's borrowers, such requirement would only be mandatory if under the relevant rules of international law, claims of certain creditors are senior to those of the Fund.
12. In international law, debt rescheduling constitutes an amendment to the financing agreements between the Fund and its borrowing Member State, which are treaties within the meaning of the Vienna Convention on the Law of Treaties between States and International Organizations or between International Organizations. Therefore, from a purely formal point of view, all treaties appear in relation to one another as independent and self-sufficient entities based on the rule *pacta sunt servanda*. Consequently, no international agreement has absolute precedent over another nor can an agreement between two or more parties be held against non-parties. The implication of the foregoing is that insofar as a borrower's debts result from agreements with other multilateral creditors, they constitute independent obligations that rank equal to each other. Indeed, with regards to the rights of the other multilateral financial institutions as third parties to the financing agreements between IFAD and its borrowers, it is a well-recognized principle of international law that a treaty does not create rights and obligations for a third party without its consent. As IFAD's financing agreements and their amendments make no provision for any third party right, no such rights may be invoked by third parties vis-à-vis IFAD, and there is no requirement under the IFAD General Conditions for Agricultural Development Financing or otherwise to give way to claims of other multilateral financial institutions.

#### **V. Conclusions**

13. The foregoing leads to the following conclusions:
  - When dealing with a country that has not yet been declared eligible under the HIPC framework, each multilateral creditor can apply its own policies to deal with the arrears of Member States.
  - Paragraph 32(g) of the IFAD Lending Policies and Criteria was introduced in 1998 by the Governing Council in order to enable the Executive Board to deal with the undesirable consequences of protracted arrears for the Member States needing the Fund assistance.
  - Accordingly, it is required by paragraph 32(g) of the IFAD Lending Policies and Criteria that arrears shall be settled by a debt rescheduling plan as decided by the Executive Board.
  - With regard to HIPC eligible countries, this authority is exercised until such time as the borrower reaches the decision point, after which the Fund is expected to operate in conjunction with the other multilateral financial institutions.
  - The responses received from the IBRD and IMF confirm that participation by creditors in the HIPC Initiative is voluntary, and therefore there is no requirement of coordinated action by all of a country's creditors. Moreover, a rescheduling on concessional terms prior to the decision point can be counted towards a multilateral organization's share of HIPC debt relief. With regards to the phrase "prior to the decision point", it was stated in the joint World Bank and IMF Note on the HIPC Initiative: Approach to Arrears to Multilateral Institutions, issued in 1998, that arrears restructuring around the time of the decision point is expected to be adopted in the context of the HIPC Initiative.

In practice, the specific period of time prior to the decision point has been applied flexibly.

- Other relevant principles of international law confirm that there is no requirement for the Fund to give way to claims of other multilateral financial institutions.