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IFAD'S POLICY FRAMEWORK FOR MANAGING PARTNERSHIPS
WITH COUNTRIES IN ARREARS

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IFAD'S POLICY FRAMEWORK FOR MANAGING PARTNERSHIPS WITH COUNTRIES IN ARREARS

Preamble

1. This document is a revised version of EB 97/61/R.9 (which revised document EB 96/59/R.73) and addresses comments made by the Executive Board at its Sixty-First Session in September 1997. The paper proposes a comprehensive policy framework for managing IFAD's operational relationships with poor countries that frequently fall into arrears with the Fund. The Executive Board requested IFAD's management: to forward the proposal to the Governing Council; to obtain Governing Council guidance on the proposed policy framework; for the Governing Council to take note of the decisions taken by IFAD management (paragraph 44); to seek the approval of the decisions taken by the Executive Board (paragraph 45) in its September 1997 session; and to seek the approval of the Governing Council of the draft resolution attached as an annex.

I. Introduction

2. On several occasions the Executive Board, the Audit Committee and the External Auditors have commented on the need for IFAD to review and strengthen its processes and procedures related to loan repayments (principal and interest/service charges). This has been and remains a subject of increasing importance, as arrears on such payments remain significant.

3. Virtually all financial institutions face arrears. They partly reflect unforeseeable and unforeseen debt service difficulties encountered by borrowers, often originating from external factors (e.g civil strife and natural disasters, see Appendix II). In these cases, they are difficult to deal with by any means other than remedial action. However, to forestall those arrears resulting from inadequate risk assessment, monitoring and follow-up, a framework for positive and pre-emptive action is required. The arrears issue is not simply a loan accounting problem. Debt service constraints are more often caused by a country's economic problems: structural, cyclical or related to economic management inefficiencies. Dealing proactively with such risk factors is an integral part of a financial institution's risk management system, which must include remedial action and eventual provisions against such arrears in order to protect the institution's financial integrity and its capacity to service the credit needs of all of its Member States equitably.

4. While IFAD management has made a number of presentations to the Audit Committee and the Executive Board at previous sessions, these have tended to concentrate on the procedural and internal accounting aspects of loan repayment and recovery of arrears. The objective of this paper is to: (a) propose a comprehensive and essentially proactive policy framework for managing IFAD's partnerships with countries that tend to fall into arrears; and (b) seek the guidance and approval of IFAD's Governing Bodies.

II. Arrears on IFAD Loans

5. As at 30 November 1997, IFAD's total arrears stood at USD 45.5 million (against USD 41.7 million in November 1995, and USD 27.1 million in November 1993). As a percentage of cumulative flows of loan repayments, the November 1997 stock of arrears amounts to 3.5%. While the amount of arrears due to IFAD is small compared to that of other international financial institutions

(IFIs) and to the total debt of the countries in question, the relatively significant build-up over the last four years highlights the implied risks for the future. Appendix I provides details on regional variations, variations by lending terms and conditions, and on IFAD's exposure to heavily-indebted poor countries. The 1997 structure of arrears, compared to the 1996 report, has not changed significantly.

III. Causes of Arrears

6. Appendix II illustrates in detail that arrears must be approached as national economic problems, most often structural in nature. IFAD needs to base its programming decisions and loan repayment policy framework on analysis of the reasons that countries fall into arrears; what kinds of structural, policy and management problems these countries face; and how we can remedy these problems while assisting the rural poor in eradicating their poverty. IFAD's policy framework needs to define how IFAD is to work with countries in arrears in a differentiated way, determined by the specific causes of their debt-service problems and arrears.

IV. IFAD's Procedures, the Consequences of Arrears and Arrears Settlement Efforts

(a) IFAD's Procedures

7. The Agreement Establishing IFAD stipulates that IFAD shall provide loans on terms the Fund deems appropriate, taking into account the economic situation and prospects of the Member State and the nature and requirements of the activity concerned. IFAD's Lending Policies and Criteria sets out IFAD's lending terms and conditions (including the terms of repayment) as summarized in Appendix III. They also stipulate that the Fund shall determine the terms and conditions to which a borrowing country is eligible, taking into account the "economic situation and prospects" of the country (especially mentioning the Communauté financière africaine (CFA) countries) and its "financial capacity" - which should include the country's level of indebtedness, its debt-servicing capacity, and the causes of its debt service constraints - and "the requirements of the activity concerned" (the project criteria). The Executive Board approves the proposed lending terms and conditions that will apply to each project.

8. IFAD developed a comprehensive policy and set of procedures for loan repayment and follow-up on arrears; they are broadly aligned with those of other IFIs except for the provisions against default or bad debts. The General Conditions Applicable to Loan and Guarantee Agreements (Article IX) and the Loan and Grant Administration Operational Manual (chapter 8) describe in detail the repayment and overdue follow-up processes, the sanctions for arrears and the exceptions (see Appendix III).

9. IFAD policies are strict with regard to loan amortization schedules. The loan is repaid in accordance with the amortization schedule set out in the Loan Agreement, which calls for semi-annual payments within the terms of the loan as approved by the Executive Board, and which, in particular, sets the last repayment date for the loan. Operational procedures provide for only three cases in which the Fund may amend a loan amortization schedule (see Appendix III). The only qualification, introduced by the Governing Council in February 1997 (document GC 20/L.6), relates to net present value (NPV) of debt relief under the Heavily-Indebted Poor Countries Debt Initiative (HIPC DI); it will amount to a de facto and ex post modification of agreed loan amortization schedules and thus of lending terms and conditions.

10. The current follow-up for loan repayments essentially consists of the dispatch of "Statements of Account" (i.e., invitations to pay), and a fax/telex-based process of follow-up and reminders of non-receipt.

(b) Consequences of Arrears

11. 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 (see Appendix III) 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.

12. No Extension of Closing Date. Projects are not eligible for extension of their loan closing dates while they are suspended.

13. Cofinancing. There is a risk that the cofinancier may also interrupt his disbursement processes, thereby further depriving the project and the country of the committed external resources.

14. 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.

15. As a consequence of this policy, and because of the current high concentration of arrears and suspensions in one region (Africa I Division), IFAD is facing difficulties in adhering strictly to the regional percentage structure of its lending programme, as approved by its Governing Bodies during 1994/1995. IFAD will continue to address this issue by managing the structure of the lending programme on the basis of a three-year rolling average, as approved by its Governing Bodies; and will continue to seek the guidance of the Executive Board on this matter of flexibility, through the annual Preview of the Programme of Work and Budget of IFAD during the September sessions of the Executive Board.

16. Impact on IFAD's Financial Resource Base. Loan arrears constitute a temporary decrease in IFAD's resources available for commitment and affect its capacity to service the credit needs of all its developing Member States equitably. In addition, arrears directly affect IFAD's income, in terms of investment income foregone. If arrears continue to increase, it may also become necessary for IFAD, at some point in the future, to make provisions for doubtful debts. This matter would need to be considered in the context of a broader review that would also take into account the issue of preferred creditor status; Executive Board and Audit Committee guidance will be sought, as and when required.

(c) Scenarios Applied for Arrears Settlement and Lessons Learned

17. When arrears occur and suspensions are applied, IFAD pursues an active dialogue with the concerned authorities to reach early settlement. When the arrears situation cannot be settled, IFAD pursues a variety of country-specific solutions (described in more detail in Appendix III). The lessons learned from these initiatives indicate that:

- (i) offsetting arrears against new reimbursement applications may handicap implementation of ongoing projects;
- (ii) IFAD needs to participate in processes leading to debt settlement arrangements funded through the International Monetary Fund (IMF) or the World Bank bridging loans or structural adjustment facilities;
- (iii) direct negotiations with governments are not always adhered to, and IFAD has no instruments to enforce the agreements other than repeated suspensions;
- (iv) as a matter of policy IFAD does not reschedule loan repayments. At most it has rescheduled the settlement of arrears, while leaving the future repayment flows intact. The Audit Committee and the Executive Board, while endorsing the settlements agreed upon, have expressed their concern that efforts for early settlement of arrears should not provide countries with an incentive to default. This amounts to an implicit expectation that the NPV of arrears settlement packages should equal the NPV of the original lending terms and conditions. This provides guidance for future policy development. Some of the approaches followed by IFAD in the past do not comply with this expectation. IFAD has sometimes sacrificed part of the NPV of expected loan repayments when the packages should have included either acceleration of maturity and/or higher "service charges" to comply with the policy expectation of constant NPV; and
- (v) most importantly, because the arrears settlement packages do not address the structural causes of debt unsustainability or arrears, the relapse risk is high.

V. Recapitulation

18. The conclusion of the analysis so far is that:

- (a) arrears is a developing issue that all financial institutions have to deal with, preferably in the context of global and coordinated initiatives;
- (b) IFAD has procedures to deal with arrears, but they are essentially reactive, not always systematically implemented, and not always effective;
- (c) in addition, IFAD's procedures are "standard", blind to country-specific situations and causes of arrears. There are strong regional differences, and heavily-indebted poor countries must be the core focus of any proactive strategy. This would call for a case-by-case approach (within a coherent framework) as advocated by the IMF/World Bank Development Committee and the G7, followed by the Paris Club;
- (d) the impact of suspensions on project implementation, local ownership and commitment to the project, beneficiary participation, and new project development is significant, particularly in poor countries. It should be noted that the suspension of loans frequently occurs in precisely those countries most in need and which are facing the most serious balance-of-payment and debt problems; and
- (e) arrears settlement packages can be designed with better protection for IFAD's financial integrity and equity among all its borrowers.

19. It is a critical fact that the Fund must deal with an ambiguity: on the one hand, IFAD has to protect its resources by avoiding the accumulation of arrears and by limiting disbursements going to

countries that are seriously in arrears and have no debt-service management plan; at the same time, IFAD must be concerned about the adverse impact of suspensions on its programme activities in the field, and in particular their impact on poverty.

20. Other financial institutions have programmatic means to help deserving borrowers deal with arrears problems (programme loans, adjustment facilities and the like), which help avoid programme interruptions. The nature of IFAD's lending and its instruments do not provide the same flexibility, and yet the need to avoid programme disruption wherever possible is particularly important if the continuity of poverty eradication efforts is not to be broken.

VI. A Debt-Service Incentive Policy Framework

21. The proposed incentive policy framework and the principles guiding its design are described in detail in Appendix IV, and will consist of a renewed dual-track policy framework based on:

- (a) proactive measures to avoid debt-service problems, arrears and suspensions;
- (b) corrective measures to deal with debt-service problems that arise.

(a) Proactive Measures to Avoid Debt-Service Problems, Arrears and Suspensions

22. Proactive measures include: maintaining positive net financial flows for the borrower; debt management capacity-building; country assessments; project design and financing choices; collaboration with the IMF and the World Bank; and participation in the HIPC Debt Initiative of the World Bank/IMF.

23. Automatic Transfers from Government Treasuries for Repayments at the de minimis Level. In its dialogue with borrowing Member Countries, IFAD needs to stress the significant cash-flow implications of small arrears, and should explore the possibility of establishing a mechanism for automatic transfers from government treasuries to service debt in general, or at least for payments of amounts below the de minimis level of USD 10 000.

24. Maintaining a Positive Net Financial Flow. The Mexico crisis and the IMF/World Bank HIPC Debt Initiative have clearly made the case for continued flows of substantial, stable levels of new external investment resources on appropriately concessional terms for productive purposes, in order to secure continued high-quality growth with poverty eradication. The resulting enhanced positive net financial flows between debtors and creditors would simultaneously contribute to sustaining rural poverty eradication efforts and enhanced debt-servicing capacity. With improvements in its current policy and procedures, IFAD will be better able to contribute to these requirements.

25. Improvements in Implementation will maintain positive net financial flows. Prompt project implementation and effective disbursement will generate the flow of fresh external resources required to support the development objectives of the country and, at the same time, to service debt due. This enhances the importance of Country Portfolio Monitoring and Management. The operational elements of portfolio management consist of implementation support and supervision. IFAD's effective presence in the field, its visibility and its usefulness will help prevent debt-service problems and arrears. It is in this context that IFAD will also work closely with its cooperating institutions (Cis) to address the debt-service issues faced by the borrowing Member States. Country Portfolio Monitoring and Management also relies on a continuous dialogue with the borrower. When it appears that a borrower may become seriously in arrears, the Fund will systematically undertake a debt review with appropriate officials of the borrowing Member State to seek practical steps to secure the management of the borrower's debts to IFAD.

26. The problem of maintaining positive net flows is particularly acute with loans on intermediate and ordinary terms, which have a five or three years' grace period, respectively, and for which repayments of the principal (defined in the Loan Agreement) become due during the early years of project implementation. The following measures, not mutually exclusive, would improve the current policy:

- (i) change the present method of calculating the grace period and timing of the first principal repayment: link the grace period to the effectiveness of the loan to reflect the actual implementation period; extend the grace period in line with the implementation period of the project, but in no case longer than six years, while maintaining a constant SDR NPV; and
- (ii) shift the basic principal repayment schedule to a "progressive instalments" method, while maintaining a constant SDR NPV.

27. It is not the objective of this proposal to enhance IFAD's engagement in its intermediate or ordinary-terms borrowing Member Countries. Its objective is solely to make its strictly limited lending to these countries more effective. IFAD will continue to focus on the poorest countries, and in particular on Sub-Saharan Africa. The Executive Board will be invited to consider the proposed specific lending terms and conditions, established on the above basis, when it considers the President's Report and Recommendation for the concerned project, in line with its established general authority for approving country eligibility to specific lending terms and conditions.

28. IFAD needs to secure prompt reprogramming of the country portfolio upon the settlement of major crises that have led to the disruption of project implementation and suspension of loan disbursements. There are countries that, in the past, have maintained a satisfactory repayment record, but which have been faced with calamities - disasters, civil disturbances - that have diminished their debt-servicing capacity. Even after these events were resolved their large overhanging arrears have been difficult to eliminate. The reactivation/launching of ongoing and new projects allows the government to pay arrears to IFAD from its own resources, and allows IFAD to replenish the projects' Special Accounts, which provides the government with foreign exchange resources.

29. Continuation of new project development during a suspension period, until the country has been placed in non-accrual status (300 days), is proposed as a matter of policy in order to reassure borrowers that new programmes can be promptly initiated once arrears are settled (although such loans would be brought to the stage of negotiation, approval and signature only in accordance with IFAD procedures). Even for countries that reach non-accrual status, a continuous dialogue will be maintained indicating the genuine interest of the Fund in undertaking additional programme activities once arrears are settled. These actions will allow the Fund to pursue settlement in concert with the borrower, which has proved to be useful in some circumstances.

30. Debt Management Capacity-Building. Support and technical assistance to build up local debt-management capacity has proven to be necessary in many countries. It is proposed that IFAD provide some strictly limited and project-linked support to this objective: possibly linking its capacity-building for early project implementation to the required capacity-building for poverty-responsive resource planning and management at central and local government levels; possibly from IFAD's technical assistance grant resources, under the category of the Special Operations Facility. IFAD would support IMF and World Bank-backed programmes with similar objectives, as also called for by the World Bank and the IMF in the context of the HIPC Debt Initiative.

31. Country Strategy Assessments: Linkage to Causes of Arrears. IFAD defines its medium-term country strategies in Country Strategic Opportunities Papers (COSOPs) that analyse country experience

and lessons learned, define the country lending programme framework and terms (which necessarily takes into account the country's level of indebtedness, its debt-servicing capacity, and the causes of its debt service constraints), and identify strategic alliances. It is proposed that COSOPs for heavily-indebted poor countries will systematically include: an assessment of debt servicing capacity, an analysis of the causes of debt-service problems, an analysis of IFAD's own debt-service problems and the consequences of arrears, and an assessment of what this analysis implies for IFAD strategy. The definition of an IFAD country strategy pertinent to debt sustainability may help secure better debt service to the Fund. IFAD will seek close collaboration with the IMF (the Policy Framework Papers) and the World Bank (the Debt Reporting System and the Country Assistance Strategies).

32. Project Design and Financing Choices. IFAD needs to reflect on its operational strategy for heavily-indebted poor countries, define a lending programme framework that focuses on these countries' needs for substantial and steady flows of new external financing, and determine what type of projects we need to finance to assist in addressing the causes of the debt service constraints. In addition to IFAD's mandatory focus on poverty eradication, the operational strategy for heavily-indebted poor countries should include the following considerations: the need for foreign exchange saving, foreign exchange earning, domestic resource mobilization, blended cofinancing, and diversification of the instruments to assist heavily-indebted poor countries, beyond IFAD's regular project lending. Programmes formulated under such a strategy will be supported with a detailed sustainability analysis.

33. Working Closely with the IMF and the World Bank, Particularly as Cooperating Institutions. In the light of their specialized macro-economic and sectoral mandates, and in particular for countries with a high risk of slipping into arrears, it is proposed to strengthen our collaboration with the IMF - especially - and the World Bank, who link their support to the settlement of arrears and who have instruments to facilitate compliance with this condition. The President of IFAD wrote to the IMF in March of 1996 proposing this collaboration, and more active follow-up is required.

34. Participation in the HIPC Debt Initiative. The objective of the recent HIPC DI is to reduce the NPV-of-debt of about 22 countries with unsustainable or stressed levels of debt (and with a track record of policy reform and structural adjustment) to a sustainable level that will not compromise their economic reform and poverty eradication efforts. The Governing Council (document GC 20/L.6) approved IFAD's participation in the HIPC DI; document EB 97/61/R.8, submitted for the consideration of the Sixty-First Session of the Executive Board, provided the details of the proposed policy framework and mechanisms for IFAD's participation, as requested by the Governing Council.

(b) Corrective Measures to Deal with Debt-Service Problems that Arise

35. Corrective measures include: better arrears follow-up, while allowing for partial suspension to honour "social contracts"; a framework for settling arrears at constant NPV terms; and mobilization of IFAD donor Member States' support.

36. Applying the Existing Procedures, with Improvements. Until 1991, and with the intention of minimizing programme disruption, IFAD's policy was to suspend only the loan actually in arrears, although the Fund had the right to suspend all project activities in the country concerned and it has done so in some cases on an ad hoc basis. However, serious arrears kept occurring, including for loans that were closed and for which suspension could not be applied. The alternative measure of acceleration of maturity is not a practical solution and has not been applied. The Fund has therefore established a revised policy under which the continuation of suspension of a loan 75 days after the due date will be followed by the suspension of the full loan portfolio for the country whenever the debt service in arrears remains outstanding for more than 120 days (i.e., 45 days after the suspension of the first overdue loan or when the first loan was subject to early maturity). All delinquent borrowers are regularly informed of the potential impact on the total portfolio if arrears remain unpaid. The Fund now also needs to apply the 150 and 300-day measures foreseen in its procedures (see Appendix III).

37. An increasing number of IFAD-funded projects are planned on the basis of cost sharing with the beneficiaries. This cost sharing is mobilized through agreements - "participation contracts" - between a wide variety of formal and informal beneficiary organizations and the project management authorities. These agreements generally commit a defined match of IFAD loan resources with the beneficiaries' own resource contributions. It is proposed that the Fund give due consideration to such "participation contracts" concluded in the context of its participatory projects, before deciding on the suspension of a loan; and it is suggested that partial suspension may be considered to permit the continued execution of the effective "participation contracts". The Loan Agreements, and Schedule 2 in particular, would need to reflect such kinds of arrangements explicitly, to permit a transparent implementation of this policy.

38. The semi-annual country portfolio reviews, chaired by the President of IFAD, would be the forum through which to manage the implementation of these elements of the policy.

39. A Framework for Settling Arrears Using the Original NPV as the Reference NPV. It is proposed to provide operational staff with a policy framework that will allow them, under policy guidance from IFAD management, to negotiate an arrears settlement package that will aim at securing, in the best way possible, the original NPV of the loan repayments, taking into account the realities of the borrower. While the settlement NPV of repayments must maintain the original reference NPV of the loan, the staff will be allowed to negotiate the different elements that compound into that NPV, and which include: the length of the repayment period, the grace period and initial arrears settlements, the interest rate, the level of instalments (and the legal instruments to secure these payments) and the currency-specific discount factor; and a linking of the package to causes of arrears and proactive initiatives. Detailed

technical guidelines and procedures will be prepared to facilitate the administration of this policy and to ensure consistency. To support the implementation of this element of the policy, IFAD would also secure the necessary staff and counterpart training, and provide the necessary budgetary resources.

40. It will be necessary to stipulate this arrangement in IFAD's General Conditions and Loan Agreements, and to keep the Audit Committee informed of arrears settlement packages of this kind. It will also be made clear to IFAD's borrowers that IFAD's participation in the HIPC Debt Initiative for their specific country will depend on full compliance with such settlement packages.

41. Mobilization of bilateral donor Member States' support in the form of loan participations of various types. Appendix IV provides more details on the range of options, but the essence of the proposal consists of the need to mobilize supplementary resources to finance a variety of new instruments through which to help poor Member States address poverty eradication while maintaining their debt at sustainable levels.

(c) The Effectiveness of the Policy

42. There is also a need to define the effectiveness of the policy, once it is approved. There are three options:

- (i) The policy would apply immediately to all arrears, current and future. The sole exceptions would be the arrears settlement packages that have been agreed upon before the date of approval of the policy, and only insofar as they are currently being strictly complied with. This is the strictest option, which is also the more equitable vis-à-vis countries that have adhered to the agreed loan amortization schedules.
- (ii) The policy would apply to arrears accruing from the date of approval of the policy onwards. This would maintain, for a considerable period of time, two types of arrears, which is not desirable.
- (iii) The policy would apply to arrears on loans that would be signed from the date of approval of the policy onwards. This would make the policy ineffective vis-à-vis current loans, and would defeat a large part of the proposed policy's objectives.

43. In its September 1997 Session, the Executive Board approved the proposed policy framework and endorsed the first option for the effectiveness of the policy: immediate applicability to all arrears. The Executive Board requested IFAD's management to forward the recommendation as such to the Governing Council for its approval.

VII. Decisions Taken by the President and the Executive Board of IFAD and Guidance
and Decisions Sought from IFAD's Governing Council

Decisions Taken by the President of IFAD

44. In accordance with the President's approval of the following elements of the proposed policy framework falling within his authority, IFAD will:

- (a) incorporate an assessment of debt-servicing capacity into each country strategy assessment for heavily-indebted poor countries (paragraph 31);
- (b) seek to adopt, in each project, design and financing choices that address the causes of the unsustainability of debt of heavily-indebted poor countries (paragraph 32);

- (c) explore with the borrowers, at the time of loan negotiations, the feasibility of establishing a mechanism for automatic financial transfers from their treasuries for loan repayments and interest/service charge payments to IFAD (paragraph 23);
- (d) in close collaboration with the CIs, improve project implementation and disbursement so as to secure enhanced positive net financial flows and maintain a dialogue with the borrowers to secure repayments as per the schedule stipulated in the Loan Agreements (paragraph 25);
- (e) secure the prompt reprogramming of a country's IFAD loan portfolio upon the settlement of major crises that have led to the disruption of project implementation and the suspension of loan disbursements (paragraph 28);
- (f) secure prompt arrears follow-up through the stricter implementation of existing procedures (paragraph 36);
- (g) continue the dialogue with a borrower on the development of the pipeline of new projects for that country when it faces debt-service problems (paragraph 29);
- (h) collaborate closely with the IMF and the World Bank (paragraph 33) on the implementation of IFAD's policy and strategy within the broader framework of debt management; and
- (i) on the basis of the decisions of IFAD's Governing Bodies (see below), develop the necessary operational guidelines and periodically inform the Audit Committee and the Executive Board on the progress made in implementing the approved policy framework.

Decisions Taken by the Executive Board

45. At its Sixty-First Session the Executive Board took the following decisions:

- (a) to amend the General Conditions Applicable to Loan and Grant Agreements to permit IFAD to settle arrears that will occur, using the original SDR net present value of the loan as a reference NPV (paragraph 39). In light of the Executive Board's decision in principle on this matter, a draft text amending the General Conditions will be presented to the Executive Board during 1998 in the context of the revision of the General Conditions;
- (b) to present, for Executive Board consideration, a limited number of programmes to support borrowers' debt management capacity-building (paragraph 30), in collaboration with other IFIs and bilateral programmes and on the basis of IFAD's current procedures for the use of technical assistance grant (TAG) resources;
- (c) to permit the President of IFAD to take into account the need to continue the execution of effective "participation contracts" with beneficiaries (paragraph 37), when considering full or partial suspension of the disbursement of a loan in response to the borrower being in arrears;

- (d) to mobilize bilateral donor Member States' support in the form of loan participations of various types; and
- (e) to submit the comments of the Executive Board together with its recommendations (listed in the section below) for consideration by the Governing Council.

Decisions for the Consideration of the Governing Council

46. The President of IFAD, on the basis of the Executive Board's comments and recommendations, requests the Governing Council to provide guidance on the proposed policy framework and invites the Governing Council to adopt a draft resolution authorizing:

- (a) amendment of the Lending Policies and Criteria (paragraph 31 thereof) to permit IFAD to take into account the indebtedness status of its borrowing Member States in defining eligibility criteria (paragraph 31);
- (b) amendment of IFAD's Lending Policies and Criteria (paragraph 32 thereof) to allow the President of IFAD to define the lending terms and conditions of ordinary and intermediate-term loans to heavily-indebted countries, taking into account the borrowers' debt sustainability status, and providing the following, not mutually exclusive, options (paragraph 26):
 - (i) changing the present method of calculating the grace period and timing of the first principal repayment: linking the grace period to the effectiveness of the loan to reflect the actual implementation period; and extending the grace period in line with the implementation period of the project, but in no case longer than six years, while maintaining SDR NPV of the standard intermediate and ordinary lending terms and conditions; and
 - (ii) shifting the basic principal repayment schedule to a "progressive instalments" method, while maintaining SDR NPV of the standard intermediate and ordinary lending terms and conditions.

47. The Governing Council also needs to consider for approval the Executive Board endorsement of the immediate and full effectiveness of the policy to all arrears (option (i) in paragraph 42).

ANNEX

DRAFT RESOLUTION ON IFAD'S POLICY FRAMEWORK FOR
MANAGING PARTNERSHIPS WITH COUNTRIES IN ARREARS

Resolution ..XXI

IFAD's Policy Framework for Managing Partnerships with Countries in Arrears

The Governing Council of IFAD,

Recalling its Resolution 83/XVII on IFAD's Lending Terms and Conditions, adopted on 28 January 1994, its Resolution 89/XVIII on the Amendment of the Lending Policies and Criteria, adopted on 26 January 1995, its Resolution 94/XIX on the Amendment of the Lending Policies and Criteria, adopted on 18 January 1996, and its Resolution 101/XX on IFAD's Participation in the Debt Initiative for Heavily-Indebted Poor Countries, adopted on 21 February 1997, all of which amended the Lending Policies and Criteria;

Reiterating the desirability of holding a periodic review of IFAD's Lending Policies and Criteria in the light of the experience gained in implementing them;

Concerned by the increase in the number of borrowers currently in arrears to the Fund and in the amount of such arrears;

Further concerned by the effect that a high level of indebtedness has upon the rural poor of the countries in such a position and on the sustainability of a country's poverty eradication efforts;

Having considered document GC 21/L.7 on IFAD's Policy Framework for Managing Partnerships with Countries in Arrears and the draft resolution contained therein;

Decides that:

1. The Lending Policies and Criteria (document IFAD 8/Rev.2) shall be amended as follows (the text to be added is underlined):

(a) In Paragraph 31 add a new sub-paragraph to read as follows:

"(e) In determining the lending terms to apply to a country, the Executive Board shall also take into account an assessment by the President of IFAD of that country's debt sustainability and its debt-servicing capacity." 1/; and

1/ Currently IFAD bases its recommendation for a country's eligibility for highly concessional or intermediate terms essentially on the country's per capita GNP. This amendment will allow the President of IFAD to take into account the country's debt sustainability and debt-servicing capacity when making a recommendation to the Executive Board for poor and heavily-indebted countries.

(b) In Paragraph 32 add the following text after sub-paragraph (e) thereof:

"(f) The Executive Board may vary the grace period and the amount of each instalment for the repayments of loans received on intermediate terms and ordinary terms. In so doing, the Executive Board, on information provided by the President of IFAD, shall take into account a country's debt sustainability and debt-servicing capacity. In submitting a proposal for the lending terms to apply to a country for a loan to the Executive Board, the President of IFAD shall ensure that: (i) the grace period for the loan, which shall be established in relation to the date on which a loan becomes effective and the date upon which disbursement of the loan is to cease, shall not exceed six years ^{2/}; and (ii) the net present value in SDR of the intermediate terms and ordinary terms specified in (b) and (c) above is maintained.

(g) 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."

2. The President of IFAD shall report periodically to the Executive Board on the arrears of borrowers to the Fund.

^{2/} The current lending terms and conditions for intermediate and ordinary loans only provide for a grace period of five and three years, respectively. As described in paragraph 26 of document EB 97/61/R.9, this often leads to the start of principal repayments when disbursements have not yet reached cruising speed, resulting in negative net resource flows between IFAD and the borrower. This amendment will allow the President to take expected disbursement profiles into account when recommending the terms for intermediate and ordinary loans to the Executive Board.

ARREARS ON IFAD LOANS

1. Regional Variations. The regional distribution of arrears on 31 July 1996 shows that 62% of the countries in arrears and 60% of total arrears are in the Africa I Region (Cameroon and Liberia account for 43%; the other arrears mainly relate to The Congo, the Democratic Republic of The Congo and Niger). The Latin America and the Caribbean Region accounts for 22%, of which Cuba represents 21.4%. The Near East and North Africa Region has also accumulated significant arrears, virtually all of them for Somalia, with some in Djibouti and The Sudan.

2. Variations by Lending Terms and Conditions. The arrears of Cuba, Cameroon and Liberia again inflate the figures concerning loans on intermediate terms, and Somalia, Cameroon and Liberia inflate the arrears on highly concessional loans. When the impact of the specific cases of Cameroon, Cuba and Liberia on the data is set aside, borrowers on highly concessional terms predictably account for the highest share of IFAD's arrears: they constitute the poorest countries, with structural problems, where IFAD's mandate calls on it to play an important role.

Distribution of HIPC's by Regional Division and Possible Timing of Decision Points a/

Africa I	Africa II	Asia and the Pacific	Latin America and the Caribbean	Near East and North Africa
Benin (1998) Burkina Faso (1998) c/ Cameroon (2000-2001) Central African Republic (2000-2001) Chad (1998) Congo (1999) Côte d'Ivoire (1998) D.R. Congo (2000-2001) Equatorial Guinea (2000-2001) Ghana Guinea (1999) Guinea-Bissau (1998) Liberia Mali (1998) Mauritania (1998) Niger (1999) Nigeria Sao Tome and Principe (2000-2001) Senegal (1998) Sierra Leone (1998) Togo (1998)	Angola (2000-2001) Burundi (2000-2001) Ethiopia (1998) Kenya Madagascar (1999) Mozambique (1998) c/ Rwanda (2000-2001) Tanzania, United Republic of (1999) Uganda (1998) b/ Zambia (1999)	Laos Myanmar (2000-2001) Viet Nam (1998)	Bolivia (1998) b/ Guyana (1998) b/ Honduras (2000-2001) Nicaragua (1999)	Somalia Sudan Yemen (1999)

Source: World Bank and IMF.

a/ This table includes all 41 HIPC's. However, current WB/IMF tables for HIPC DI exclude seven countries: Liberia and Somalia (for lack of information); Nigeria (which is not IDA-only); Ghana, Kenya and Laos (which have never received a concessional rescheduling from the Paris Club); and The Sudan (for which no allowance has been made for possible participation in the HIPC DI).

b/ Completion point assumed to be one year after decision point.

c/ Completion point assumed to be two year after decision point.

3. IFAD's Exposure to Heavily-Indebted Poor Countries (HIPC's). Recently, important international initiatives have been undertaken to address the impact of high levels of debt and debt service on the economic sustainability of developing countries. These initiatives have focused on 41 of the poorest countries with high levels of debt, the heavily-indebted poor countries (HIPC's). About 22 of these countries are considered to have stressed or unsustainable levels of debt. All of these HIPC's are eligible for IFAD's highly concessional terms and conditions. The above table shows the distribution of HIPC's by IFAD regional division; it is based on 1994 data computed by the World Bank for the Preliminary Debt Sustainability Analyses. All divisions are concerned, particularly Africa I and Africa II, although Africa II is currently less affected by arrears than Africa I. IFAD's emphasis on highly concessional terms for poor borrower countries, particularly in Sub-Saharan Africa, makes this list even more pertinent.

4. Of the 36 countries that had accumulated arrears with IFAD as of 31 July 1996, 25 are HIPC's. Ten are classed in the "Sustainable Debt" category; seven in the "Stressed" category; five in the "Unsustainable" category, and three in "To Be Determined". HIPC's account for 72.1% of arrears due to IFAD, and countries with sustainable levels of debt account for only 1.6% of this figure. Eighty-one per cent of IFAD's current exposure (not including expected interest payments) to countries in arrears is to these HIPC's. The HIPC's account for 119 out of the 140 projects ongoing in countries in arrears, and ten of the eleven suspended projects are in HIPC's. This provides a strong argument for IFAD's participation in international initiatives, such as the HIPC Debt Initiative, as a suitable framework for addressing IFAD's debt-service issues.

CAUSES OF ARREARS

1. The table below provides an inventory of the causes of indebtedness and reasons why countries fall into arrears, together with the possible support that international financial institutions (IFIs) can provide to assist borrowers in resolving these problems. These support measures also define the substantive elements of the policy framework required to deal with arrears.
2. The scale of the indebtedness indicators for the HIPCs results from the combined effect of sizeable external resource inflows and low growth rates for output and exports over the past decade. A number of factors have contributed to the relatively weak economic performance of these countries, including adverse developments in terms of trade and the incidence of drought and civil war. Deficiencies in macro-economic management and the persistence of micro-economic distortions and structural weaknesses have also played a significant role. The pace of policy reform, economic stabilization, structural adjustment, and broad-based participation in a high-quality growth process have remained uneven.
3. Unsustainable debt^{1/} is generally the result of the simultaneity and interaction of several of these different elements, which makes it spurious to establish their relative weights in general. However with some degree of confidence one can generalize the basic "debt spiral" in the following terms. The main initial problem has been the adoption of growth models that cannot be sustained by the domestic, particularly the fiscal, resource base. This has led to increasing fiscal deficits, not only crowding out private investment, but also calling for increasing levels of internal and, more importantly, external debt. This debt not only distorts internal savings/investment and demand patterns and relative resource costs, but also worsens the balance-of-payment and foreign exchange reserve situation of the country. Servicing the debt in turn puts new pressure on fiscal resources, particularly under tightened monetary policy scenarios, too often resulting in additional borrowing on increasingly unfavourable terms and conditions.
4. Obviously, the main direct cause of arrears is the unsustainable debt burden of many heavily-indebted poor countries in relation to the current structure of their export base. This situation may compromise these countries' efforts to complete their economic policy reform and structural adjustment programmes, and may deprive them of the opportunity to deal with poverty eradication through structural changes. International initiative, i.e., mobilizing the full spectrum of institutions that can structurally assist poor countries in developing the macro-economic (e.g., the International Monetary Fund (IMF) and the World Bank), micro-economic and institutional solutions (e.g., IFAD) to unsustainable debt, is long overdue.
5. Arrears must be approached as national economic problems. IFAD needs to base its programming decisions and loan-repayment policy framework on analysis of the reasons that countries fall into arrears; what kinds of structural, policy and management problems these countries face; and how we can remedy these problems while assisting the rural poor in eradicating their poverty. IFAD's policy framework needs to define how IFAD is to work with countries in arrears in a differentiated way, determined by the specific causes of their debt-service problems and arrears.

^{1/} Debt is considered sustainable if its net present value (NPV) (discounted at 10%) amounts to a debt-to-exports ratio lower than 200-250%, and if the debt service ratio is lower than 20-25%.

Causes of Indebtedness and Arrears

Causes ^{1/}	IFI Solutions: Support
Civil unrest - leading to military expenditure and export revenue losses	risk assessment and risk avoidance policy
Natural disasters - leading to rehabilitation expenditures and export revenue losses	risk assessment and risk mitigation strategies
Macro-economic causes	better macro-economic policy and better policy reform performance
Overvaluation of currencies Exchange rate developments: 1. depreciation of USD (preferred currency of payment for majority of loans) to SDR 2. depreciation of local currencies - increasing domestic costs of foreign debt, and - limiting absorptive capacity of new external financing	sound monetary and exchange-rate policy: - encourage private-sector investment - control crowding out by public sector
International interest-rate developments	more blending
Excessive debt and inadequate concessionality of past borrowing	participation in HIPC Debt Initiative (DI), and application of IMF ceilings
Current account deficits and decline in foreign exchange reserves	foreign exchange saving and generation
Reversals in foreign investment flows	increasing or stabilizing them
Unsustainable fiscal deficits, financed with external resources, further increasing the external debt burden on government budget	fiscal policy reform: - emphasize domestic resource mobilization - broaden the tax base
Structural and micro-economic causes	structural adjustment
Capital-intensive (imports) and unproductive past investments, and inadequate foreign exchange saving or creation of investments	appropriate type of investments, better implementation for impact and better foreign exchange absorption
International commodity prices and narrow export base	economic diversification and broader export base
Economic policy bias against agricultural production	policy dialogue
Institutional constraints on absorbing new external financing	capacity-building and private-sector mobilization
Lack of broad-based participation in high-quality growth (sustainable, poverty eradicating)	broader participation of the smallholders and micro-entrepreneurs, based on improved distribution of productive assets
Institutional bottlenecks in debt management: 1. problems of debt reporting due to lack of staff, data problems, inadequate administrative arrangements and simple neglect 2. delays due to discussions between central and local governments on foreign exchange repayments (foreign exchange risks)	capacity-building clarity at loan-signing stage

^{1/} IFAD's debt-service incentive policy framework aims at directly eliminating the scenario of possible "wilful default".

IFAD'S PROCEDURES, THE CONSEQUENCES OF ARREARS AND
ARREARS SETTLEMENT EFFORTS

The Agreement Establishing IFAD and IFAD's Lending Policies and Criteria

1. The Agreement Establishing IFAD stipulates that IFAD shall provide loans on terms the Fund deems appropriate, having regard to the economic situation and prospects of the member and the nature and requirements of the activity concerned. The document IFAD's Lending Policies and Criteria sets out IFAD's lending terms and conditions, summarized in the box below. It also stipulates that the Fund shall determine the terms and conditions to which a borrowing country is eligible, taking into account the "economic situation and prospects" of the country (especially mentioning the Communauté financière africaine (CFA) countries), and its "financial capacity" - which necessarily includes the country's level of indebtedness, its debt-servicing capacity and the causes of its debt service constraints; and "the requirements of the activity concerned" (the project criteria). The Executive Board approves the proposed lending terms and conditions that will apply to each project.

<p style="text-align: center;"><u>Highly concessional terms</u></p> <ul style="list-style-type: none">- applicable to countries with a GNP or GDP per capita of USD 805 or less in 1992 prices, or IDA-only countries;- no interest, but an annual service charge of 0.75% (1% for loans approved before April 1994);- with a maturity of 40 years (50 years for loans approved before April 1994), including a grace period of 10 years.
<p style="text-align: center;"><u>Intermediate terms</u></p> <ul style="list-style-type: none">- applicable to countries with a GNP or GDP per capita between USD 806 and USD 1 305 in 1992 prices;- annual interest rate set at 50% of the variable July-December IBRD reference interest rate (4% for loans approved before April 1994);- with a maturity of 20 years, including a grace period of 5 years.
<p style="text-align: center;"><u>Ordinary terms</u></p> <ul style="list-style-type: none">- applicable to countries with a GNP or GDP per capita of USD 1 306 or above in 1992 prices;- annual interest rate set at 100% of the variable July-December IBRD reference interest rate (8% for loans approved before April 1994);- with a maturity of 15 to 18 years, including a grace period of 3 years.

2. Neither of the documents address the issue of arrears on IFAD loans. As presented below, IFAD developed the General Conditions Applicable to Loan and Guarantee Agreements (approved by the Executive Board) and the Loan and Grant Administration - Operational Manual to deal with this gap.

General Conditions Applicable to Loan and Guarantee Agreements and the Loan and Grant Administration Manual

3. IFAD developed a comprehensive policy and set of procedures for loan repayment and follow-up on arrears; they are broadly aligned with those of other IFIs, except for the provisions against default or bad debts. The General Conditions Applicable to Loan and Guarantee Agreements (Article IX) and the Loan and Grant Administration - Operational Manual (chapter 8) describe in detail the repayment and overdues follow-up processes, the sanctions for arrears and the exceptions.

4. IFAD's policies are strict with regard to loan amortization schedules:

- (a) The loan is repaid in accordance with the amortization schedule set out in the Loan Agreement, which calls for semi-annual payments within the terms of the loan, as approved by the Executive Board, and which, in particular, sets the last repayment date for the loan.
- (b) Operational procedures provide only three cases in which the Fund may amend a loan amortization schedule^{2/}
 - (i) when no disbursement on the loan has been made at the time the first amortization falls due, or when an instalment is higher than the amount disbursed;
 - (ii) when a portion of the loan amount has been cancelled during project implementation or on loan closing, which calls for an accounting adjustment of the loan amount; and
 - (iii) when project implementation is substantially delayed and the project is starting to take off effectively at the time the grace period comes to an end. In this case the level of the first few principal repayments can be reduced, but these need to be compensated by increases in subsequent principal repayments (EB 91/44/R.59). This possibility only relates to loans on intermediate or ordinary terms, and would only be instituted in particular circumstances where the Fund believes that delays were justified and that the project will significantly benefit from a limited adjustment of the amortization schedule.

5. The follow-up for loan repayments essentially consists of the dispatch of "Statements of Account" (i.e., invitations to pay), and a fax/telex-based process of follow-up and reminders of non-receipt. When overdues are not paid:

- (a) after 75 days, IFAD suspends disbursements of the affected disbursing loan and warns the borrower of the possible suspension of all other loans within 45 days;
- (b) after 120 days, IFAD suspends disbursements of all disbursing loans for that borrower and accelerates maturity in the case of closed or fully-disbursed loans;

^{2/} In these three cases, such a change does not effectively modify the terms and face value of the loan as approved by the Executive Board. Therefore it is handled directly by the Loans Section of the Controller's Office in consultation with the Project Management Department and Legal Services Division.

- (c) after 150 days, IFAD reviews the situation and decides on subsequent action to be taken on a case-by-case basis; and
- (d) after 300 days, the affected loan is placed in non-accrual status.

6. *De Minimis Procedure.* When the amount due is less than USD 10 000, and in order to minimize disruption due to very small levels of arrears, IFAD sends the normal advance notices, payment notifications and overdue reminders, but no further suspension action is taken unless another loan is overdue for more than 120 days, at which point the whole portfolio, including the loan(s) subject to the de minimis procedure, is suspended.

Consequences of Arrears: Suspension of Projects and Country Portfolio.

7. The most important consequence of arrears is the suspension of loan disbursements. An analysis of suspensions on IFAD loans indicates the following:

- (a) the frequency of suspensions and their length is bound to have a negative impact on the quality of project implementation, beneficiary participation and commitment to the "social contracts" built into an increasing number of projects, project staff morale, and consequently on poverty eradication. It should be noted that project implementation is not discontinued per se, and the cooperating institutions continue supervision and processing of withdrawal applications, to be honoured when the suspension is lifted or if the payment is covered by the specific list of exceptions to the rule (special commitments under letters of credit, contracts signed before the suspension date, etc.). However projects that depend entirely on the external financing, which is the case in the poorest countries, come to a halt;
- (b) while Latin American projects suffer from a higher average number of days of suspension, Africa I projects suffer from shorter but more frequent suspensions. IFAD-initiated and exclusively-financed projects have fewer suspensions, while IFAD-initiated and cofinanced projects have shorter suspensions. Loans on ordinary terms have fewer but longer suspensions, possibly indicating that arrears are only incurred when there are structural problems in servicing debt; while highly concessional loans have short but frequent suspensions, indicating that debt management problems aggravate the structural issues.

Scenarios Applied for Arrears Settlement and Lessons Learned

8. When arrears occur and suspensions are applied, IFAD pursues an active dialogue with the concerned authorities to reach early settlement. When the arrears situation cannot be settled, IFAD pursues a variety of country-specific solutions including:

- (a) direct settlement of arrears by offsetting the amount overdue against withdrawal applications for reimbursement;
- (b) direct negotiation of a bridging loan from the World Bank (in the framework of a structural adjustment facility) to the Government, to ensure the payment of arrears to IFAD and to permit the lifting of loan suspension;

- (c) various direct negotiations with governments of arrears settlement packages that include several of the following elements:
- agreement on a repayment plan, settling the arrears and from there onwards adhering to the original loan amortization schedule;
 - the payment of a significant portion of the arrears with immediate effect;
 - short-term promissory notes to be encashed by IFAD at their maturity;
 - provisions in the national budget to pay forthcoming current amounts of loan charges at due date; and
 - the participation in a debt settlement arrangement to be funded with bridging loans from the IMF or the World Bank.

A DEBT-SERVICE INCENTIVE POLICY FRAMEWORK

The Principles

1. On the basis of the above assessment IFAD's management defined the following guiding principles for the design - the policy framework must:

- (a) be equitable for all IFAD's Member States, and therefore provide borrowing countries with a strong incentive framework for prompt debt servicing, as stipulated in the Loan Agreements;
- (b) preserve IFAD's financial integrity and its capacity to service the eligible credit needs of all its developing Member States equitably;
- (c) be proactive and built into the re-engineered Project Development Cycle (particularly features like the Country Strategic Opportunities Paper and Country Portfolio Management) and IFAD's risk management system;
- (d) be simple to implement and monitor;
- (e) be flexible, i.e., realistic, allowing IFAD's operational staff to take into account the economic potentials and constraints of the specific borrowing countries;
- (f) be consistent with the generally accepted principles applicable to multilateral development banks or to IFIs and be managed in close collaboration with the latter; and
- (g) have the potential of mobilizing the financial support of IFAD's non-borrowing Member States, in particular those that are members of the Paris Club.

The Proposed Policy Framework

2. The proposed Incentive Policy Framework consists of a renewed dual-track policy framework based on:

- (a) proactive measures to avoid debt-service problems, arrears and suspensions; and
- (b) corrective measures to deal with debt-service problems that arise.

A. Proactive Measures

3. Proactive measures include: maintaining positive net financial flows for the borrower; debt management capacity-building; country assessments; project design and financing choices; collaboration with the IMF and the World Bank; and participation in the HIPC Debt Initiative of the World Bank/IMF.

Increasing the *De Minimis* Level

4. There may appear to be merit in increasing the *de minimis* level from the current USD 10 000, but it is possible that this would merely postpone the problem, as it does not address the causes of arrears. IFAD's dialogue with the borrower needs to stress the significant cash-flow implications of such small arrears, and should explore the possibility of establishing a mechanism for automatic transfer from treasuries to service debt in general, or at least for payments of amounts below this level.

Maintaining a Positive Net Financial Flow

5. The recent Mexico crisis and the IMF/World Bank HIPC Debt Initiative have clearly made the case for continued flows of substantial, stable levels of new external investment resources on more concessional terms for productive purposes, in order to secure continued high-quality growth with poverty eradication. The resulting enhanced positive net financial flows between debtors and creditors would simultaneously contribute to sustaining rural poverty eradication efforts and enhanced debt-servicing capacity. The current policy of IFAD deals with this preoccupation, but with some improvements in its current procedures, IFAD will be better able to contribute to these requirements through:

- (a) faster disbursement on committed loans and managing repayments to IFAD so as to maintain positive net financial flows for the borrower;
- (b) swift reprogramming of ongoing projects after a major crisis; and
- (c) new project development.

Managing Financial Flows

6. Improve Implementation. While the country's overall financial situation is the primary structural cause of arrears, project implementation difficulties, such as delayed project start-up and disbursement delays, may further deprive the country of means that could help it resolve its debt-service problems (i.e., reimbursements and, for some types of projects, export revenues). Prompt project implementation and effective disbursement will generate the flow of fresh external resources required to support the development objectives of the country and, at the same time, to service debt due. This will assist in avoiding arrears and suspensions of loan disbursements, which become particularly stressing when project cash flows are affected by the suspension of new reimbursements while repayment obligations from interest and principal continue to increase.

7. This enhances the importance of Country Portfolio Monitoring and Management. The operational elements of portfolio management consist of implementation support and supervision. IFAD's effective presence in the field, its visibility and its usefulness will help prevent debt-service problems and arrears. Implementation support helps countries realize the expected economic benefits (export revenue or import substitution) from the investment of external financial resources. In addition, prompt implementation and disbursement will not only ensure positive net resource flows for the country, facilitating debt servicing, but will also help the borrowers in allocating scarce debt-service resources to IFAD debt.

8. Country Portfolio Monitoring and Management also relies on a continuous dialogue with the borrower. When it appears that a borrower may become seriously in arrears, the Fund will undertake a debt review with appropriate officials of the borrowing Member State to seek practical steps to secure

the management of the borrower's debts to IFAD. Loan administration missions have proven useful, and have on many occasions provided loan repayment guidance.

9. The problem of maintaining positive net flows is particularly acute with loans on intermediate and ordinary terms, with a five or three years' grace period, respectively, and with repayment of the principal (defined in the Loan Agreement) becoming due during the early years of project implementation. Implementation delays may lead to a situation where principal repayments are required at the same time or at close to the same level as disbursements. This risk is particularly important in the Latin America and the Caribbean Region, where loans on intermediate or on ordinary terms are more frequent. The following measures, not mutually exclusive, would improve the current policy:

- (a) Change the present method of calculating the timing of the first principal repayment instalment:
 - (i) The first principal repayment is due when the grace period ends. The timing the first instalment of loan repayment is calculated on the basis of the date of Board approval of the loan, with a margin of six to nine months corresponding approximately to the period necessary to make a loan effective. From past experience, this does not reflect the average period required to reach loan effectiveness. Therefore, the grace period in many cases is shorter than envisaged at Board approval. It is proposed to link the grace period to the effectiveness of the loan to reflect the actual implementation period, and to increase the grace period duration from three to five years.
 - (ii) Extend the grace period on ordinary and intermediate terms loans in line with Executive Board approved project implementation period for each project, but in no case longer than six years, and at constant basic NPV.
- (b) As a matter of general rule, shift the basic principal repayment schedule of loans on ordinary and intermediate terms from the equal semi-annual instalments method to a progressive instalments method, at constant basic NPV.

10. Reprogramme the Country Portfolio after a Crisis. This possibility can be illustrated by the recent example of Rwanda. Upon the settlement of a major crisis that led to the disruption of project implementation and suspension of loan disbursements, IFAD has been able to mobilize itself rapidly to reprogramme the Fund's portfolio in the country. Consultations between the government and IFAD resulted in an arrangement where the government agreed to pay IFAD's arrears from its own resources, provided that IFAD will reactivate the ongoing projects, launch the approved projects that were not yet effective and ensure the rapid development of new projects. The reactivation/launching of ongoing and new projects allowed the replenishment of the projects' Special Accounts, thereby also providing the government with foreign exchange resources.

11. Continue New Project Development. The Fund has procedures that directly relate the processing of new projects and the approval of new loans to a country's arrears situation with IFAD. These procedures would require more selective implementation to secure continued new resource flows in particular to the poorest of these countries in difficulty. It is proposed as a matter of policy that during a suspension period, until the country has been placed in non-accrual status, project development should continue in order to reassure borrowers that new programmes can be promptly initiated once arrears are settled (although such loans would be brought to the stage of negotiation, approval and signature only in accordance with IFAD's procedures). Even for countries that reach non-accrual status,

a continuous dialogue will be maintained indicating the genuine interest of the Fund in undertaking additional programme activities once arrears are settled. These actions will allow the Fund to pursue settlement in concert with the borrower, which has proved to be useful in some circumstances.

Debt Management Capacity-Building

12. Technical assistance to build up debt-management capacity has proven necessary in many countries. If it would not be feasible for IFAD to fund such objectives with its technical assistance grant resources (possibly combined with capacity-building for poverty-responsive development resource planning and management at central and local government levels), IFAD would need to support the IMF and World Bank programmes that have such direct objectives, perhaps in the context of the HIPC Debt Initiative with its programme-implementation monitoring activities.

Country Strategy Assessments: Linkage to Causes of Arrears

13. IFAD defines its medium-term country strategies in Country Strategic Opportunities Papers (COSOPs) that analyse country experience and lessons learned, define the country lending programme framework and terms (which necessarily takes into account the country's level of indebtedness, its debt-servicing capacity, and the causes of its debt-service constraints), and identify strategic alliances. It is proposed that COSOPs for heavily-indebted poor countries would include an assessment of debt-servicing capacity, an analysis of the causes of debt-service problems and what this analysis implies for IFAD strategy. The definition of an IFAD country strategy pertinent to debt sustainability may help secure better debt service to the Fund. IFAD will seek close collaboration with the IMF (the Policy Framework Papers) and the World Bank (the Debt Reporting System and the Country Assistance Strategies).

Project Design and Financing Choices

14. IFAD needs to reflect on its operational strategy for heavily-indebted poor countries (the ideas), define a lending programme framework that focuses on these countries' needs for substantial and steady flows of new external financing, and determine what type of projects we need to finance to assist in addressing the causes of the debt-service constraints.

15. In addition to IFAD's mandatory focus on poverty eradication, the elements of the operational strategy for heavily-indebted poor countries should consider the need for:

- (a) foreign exchange saving (local procurement; restrict loan financing to foreign exchange costs, unless we want to finance local costs as budgetary and balance-of-payments support; import substitution);
- (b) foreign exchange earning (export production);
- (c) mobilizing of domestic resources, with more emphasis on self-help approaches, savings mobilization, and cost recovery, with a better analysis of project sustainability, in particular with respect to the fiscal impact of the projects;
- (d) better-blended cofinancing, mobilizing more grant cofinancing; and
- (e) diversification of the instruments at the disposal of IFAD to assist heavily-indebted poor countries, beyond IFAD's regular project lending.

It is also proposed that all technical, management and Executive Board reviews of project proposals for heavily-indebted poor countries consider the proposals in the light of the debt sustainability analysis provided in the COSOPs.

Working Closely with the IMF and the World Bank, Particularly as Cooperating Institutions

16. For countries with a high risk of slipping into arrears, it is proposed to strengthen our collaboration with the IMF and the World Bank, who link their support to the settlement of arrears and who have instruments to facilitate compliance with this condition, and with the other partners in the HIPC Debt Initiative. The President of IFAD wrote to the IMF in March of 1996 proposing this collaboration; the World Bank has a standing procedure for collaboration with other IFIs (BP 14.10, paragraph 7), which we need to activate. Of course the HIPC Debt Initiative itself will provide us with such a collaborative framework, and will ensure that settlement of arrears to IFAD are included in any debt settlement packages being negotiated by these institutions.

Participation in the HIPC Debt Initiative

17. The EB document (EB 97/61/R.8), considered by the Sixty-First Session of the Executive Board, provides the details of IFAD's policy and mechanisms for participation.

B. Corrective Measures

18. Corrective measures include: better arrears follow-up and partial suspension to honour "social contracts"; a framework for settling arrears at constant NPV terms; and mobilization of IFAD's donor Members States' support.

19. Applying the Existing Procedures, with Improvements. Until 1991, and with the intention of minimizing programme disruption, IFAD's policy was to suspend only the loan actually in arrears, although the Fund had the right to suspend all project activities in the country concerned and it has done so in some cases on an ad hoc basis. However, serious arrears kept occurring, including for loans that were closed and for which suspension could not be applied. The alternative measure of acceleration of maturity is not a practical remedy. The Fund has therefore established a revised policy under which the continuation of suspension of a loan 75 days after the due date will be followed by the suspension of the full loan portfolio for the country whenever the debt service in arrears remains outstanding for more than 120 days (i.e., 45 days after the suspension of the first overdue loan or when the first loan was subject to early maturity). All delinquent borrowers are regularly informed of the potential impact on the total portfolio if arrears remain unpaid. The Fund now also needs to apply the 150 and 300-day measures foreseen in Appendix II.

20. The above measures would be facilitated by securing IFAD's Preferred Creditor Status (PCS). The Agreement Establishing IFAD and IFAD's Lending Policies and Criteria are also silent on a PCS for IFAD. The IMF and the World Bank attach much importance to this status, which secures them repayment priority over other creditors, and which contributes to securing their Triple A Ratings in the financial markets. The World Bank stipulates its PCS in its Loan Agreements/General Conditions in order to secure its enforcement. Although, in practice, multilateral organizations have obtained preference over individual bilateral donors, it may be useful for IFAD to follow the World Bank's practice.

21. It is, however, proposed that the Fund give due consideration to the "participation contracts" concluded in the context its participatory projects, before deciding on the suspension of a loan; and it is suggested that partial suspension be considered to permit the execution of the effective social contracts.

22. A Framework for Settling Arrears Using the Original NPV as the Reference NPV. IFAD's lending terms and conditions (which do not include commitment fees) have been established by the Governing Bodies. As indicated above, arrears and arrears settlements have affected these NPVs, which may provide countries with an incentive to fall into arrears.

23. IFAD's lending terms and conditions are fixed in the recently amended Lending Policies and Criteria. Apart from a discretion to vary the maturity period for ordinary term loans within a range of 15 to 18 years, no discretion has been provided to the Fund's management for the variation of those basic terms. Any proposal for modifying the basic lending terms and conditions or their administration would need to be approved by the Governing Council.

24. However the General Conditions Applicable to Loan and Guarantee Agreements, Section 9.08(a), permits IFAD to accelerate the maturity (but not change the interest rate or other terms) of a loan if the borrower fails to pay interest or repay the loan amount. This is available as a final sanction after disbursements have been suspended and/or the loan cancelled. In providing this discretion to accelerate the loan maturity period, the General Conditions provide a first instrument for IFAD to deal with repayments and arrears in NPV rather than Face Value terms, as is currently the practice.

25. It is now proposed to provide operational staff with a policy framework that will allow them, with management policy guidance, to negotiate an arrears settlement package that will secure the NPV of the loan repayments, taking into account the realities of the borrower. While the settlement NPV of repayments must be the same as the original NPV of the loan, the staff will be allowed to negotiate the different elements that determine that NPV, and which include:

- (a) shortening the repayment period, using IFAD's authority to accelerate maturity;
- (b) setting realistic grace periods and initial arrears settlements, taking into account project implementation - i.e., the net flow of resources - and the special issue of ordinary and intermediate loans;
- (c) redefining the interest rate and defining rebates for earlier repayment. This could also take the form of supplementary service charges or commitment charges;
- (d) setting the level of instalments;
- (e) following IMF guidelines, using currency-specific interest rates as the discount factor; and
- (f) linking the package to causes of arrears and proactive initiatives.

26. It will also be necessary to stipulate this arrangement in IFAD's General Conditions Applicable to Loan and Guarantee Agreements, and to keep the Audit Committee informed of arrears settlement packages of this kind. It will also be made clear to IFAD's borrowers that IFAD's participation in the HIPC Debt Initiative for their specific country will depend on full compliance with such settlement packages.

27. Bilateral Donor Member States' Support - Loan Participations. At any time during the life of a loan, a donor may participate in a loan by contributing resources to be used to pay off part of the

repayments. Billing statements are adjusted to take any such contributions into account. While the Fund urges borrowers themselves to meet their commitments to IFAD, it must be recognized that there are circumstances where specific countries may need to be assisted to return as quickly as possible to creditworthiness. It would be desirable if donors could assist deserving countries in meeting their current IFAD arrears, so that the Fund can resume project activities. While it is appreciated that donors are generally reluctant to assist in clearing arrears with IFIs, it must be recalled that those institutions often have other programmatic means of assisting deserving borrowers in meeting their debt problems. Given the relatively small amounts that deserving borrowers owe to IFAD, and the disruption that suspension causes for those programmes, IFAD will seek special contributions to this effect. It will be recalled that two donors have already provided grants to assist borrowers in meeting their requirements for repayment to IFAD, though this was done in the absence of arrears by the borrowers.

28. Cash contributions could also be earmarked exclusively for the settlement of the upfront arrears settlement portion (as a grant for highly concessional borrowers, and as a grant or highly concessional loan for intermediate and ordinary borrowers).

29. IFAD could also explore the possibility of donor support for debt-equity swaps to alleviate the NPV-burden of current debt of its borrowers.

30. This is obviously an area where the Resource Management Strategy Team could take an active role in mobilizing supplementary or Special Programme resources.