



IDA15

**FURTHER ELABORATION OF A SYSTEMATIC
APPROACH TO ARREARS CLEARANCE**

**International Development Association
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Abbreviations and Acronyms

AfDB	African Development Bank
AfDF	African Development Fund
AsDB	Asian Development Bank
BIS	Bank for International Settlements
BP	Bank Procedures
CP	Completion Point
CRN	Country Re-engagement Note
CRS	Creditor Reporting System
DP	Decision Point
DRC	Democratic Republic of Congo
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
EPCA	Emergency Post-Conflict Assistance
FY	Fiscal Year
GDF	Global Development Finance
GDP	Gross Domestic Product
GNI	Gross National Income
HIPC	Heavily Indebted Poor Country
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
I-PRSP	Interim Poverty Reduction Strategy Paper
ISN	Interim Strategy Note
IMF	International Monetary Fund
LICUS	Low Income Country Under Stress
MDB	Multilateral Development Bank
MDRI	Multilateral Debt Relief Initiative
NPV	Net Present Value
OP	Operational Policy
TSS	Transitional Support Strategy
RAP	Rights Accumulation Program
WEO	World Economic Outlook

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Executive Summary

At the first IDA15 meeting in Paris in March 2007, the IDA Deputies welcomed Management's proposal for clearing Liberia's arrears to IBRD and IDA through an exceptional arrears clearance allocation from IDA and broadly supported Management's proposal on how to address similar cases in the future through a systematic approach for arrears clearance. This paper provides additional details on the systematic approach, including a more detailed and comprehensive financing framework as requested by the IDA Deputies.

A systematic approach is needed as IDA confronts the serious arrears problems of the seven countries in arrears to IDA. Three of these countries also have arrears to IBRD, and their combined IBRD and IDA arrears amount to US\$2.36 billion. Unlike previous cases, which were handled under existing Bank policies on a case-by-case basis, the arrears of these countries are so large that it is unlikely in most instances that they can be cleared using domestic resources, or by relying on countries' respective IDA allocations, as has been done in some recent cases. At the same time their circumstances vary widely, for instance with respect to their economic and financial capacity, their level of indebtedness, and their eligibility for debt relief. These factors will impact how an arrears clearance package would be designed, including with respect to country payments. This, in turn, implies that while an approach to arrears clearance can be systematic, it would not lead to equal outcomes across countries. Rather, it would achieve equality of treatment through the consistent application of criteria that recognize the differences in specific country situations.

The approach would cover IDA eligible countries with arrears to IBRD and/or IDA as of December 31st, 2006 and grandfathered for eligibility under the HIPC Initiative but that have yet to reach the HIPC decision point. Two countries, Myanmar and Zimbabwe, would need to be grandfathered into HIPC before they could be eligible for exceptional arrears clearance support. Eligible countries would only be able to receive exceptional arrears clearance support after meeting the Bank's requirements for re-engagement, as well as conditions for each operation to finance arrears clearance. Such conditions would include a medium-term growth-oriented reform program, satisfactory performance under a Fund program, and a financing plan that provides for the full clearance of arrears to the Bank and for the normalization of relations with other multilateral institutions where there are also arrears to those institutions. The risks linked to providing exceptional support for arrears clearance are mitigated by a number of factors and preventive measures, including recent IDA policies relating to grants, debt relief and non-concessional borrowing.

IDA pre-arrears clearance grants allow IDA to engage early with countries emerging from conflict. To make such grants more effective in the case of the countries now in arrears, Management would propose several changes to existing policy, including to: (i) extend their use in countries where arrears clearance is delayed for reasons unrelated to a country's track record; (ii) implement flexibly the condition that requires other creditors to agree not to make net withdrawals of financial resources; and (iii) broaden eligibility for such grants to all countries declared eligible for the exceptional arrears clearance support from IDA.

The factors that determine the cost of each arrears clearance exercise, including the timing of arrears clearance, country capacity to finance arrears clearance, and the requirements of other creditors cannot be precisely estimated in advance. Once a country begins the process of re-engagement, staff would undertake an assessment of its capacity to finance a share of the arrears from domestic resources and its IDA allocation. For this assessment, staff would examine the availability of domestic resources and the country's debt sustainability and financing gap. The result of the assessment would form the basis for the calculation of the level of the exceptional allocation required for arrears clearance. The Executive Directors of IDA would need to approve each arrears clearance operation, and thus also each exceptional arrears clearance allocation as they are presented to the Executive Directors.

While noting the many uncertainties that could affect the final cost of exceptional support for arrears clearance, Management's indicative and conservative estimate is that US\$1.4 billion would be required to cover the costs that are likely to be incurred before the end of the IDA15 period. In terms of the additionality of this cost for donors, it is important to note that concessional support for arrears clearance is counted as debt relief under the rules of the HIPC Initiative. Thus any such support leads to a commensurate reduction in the amount of HIPC debt relief from IDA that donors would need to finance during the interim period or at the HIPC completion point. Exceptional IDA support for arrears clearance effectively frontloads the delivery of HIPC debt relief.

Donor financing to cover the cost of exceptional support for arrears clearance would be treated as a set-aside financing contribution. In the unlikely event that there are any unused resources during IDA15 they would be carried over into IDA16. Conversely, any shortfall under the approach during IDA15 would need to be made up in IDA16. It is also proposed to widen the scope of the HIPC Trust Fund so that it could receive donor contributions for arrears clearance, as well as potential IBRD net income transfers to address any remaining structural gap in the MDRI financing framework of IDA.

Further Elaboration of a Systematic Approach to Arrears Clearance

I. Introduction

1. At the first IDA15 meeting the IDA Deputies discussed how to move forward with the clearance of Liberia's arrears to IBRD and IDA, as well as a framework for addressing similar cases in the future. The discussion was based on a paper reviewed by the IDA's Executive Directors on February 8, 2007.¹ Participants welcomed Management's proposal for clearing Liberia's arrears with an exceptional IDA allocation. They also broadly supported the key elements of the proposed systematic approach, including the eligibility criteria, use of exceptional IDA allocations, financing of arrears clearance through IDA replenishment discussions on a burden-shared basis, the widening of the HIPC Trust Fund and harmonization of IFIs' approaches to arrears clearance. Management agreed to provide additional details on the systematic approach, including a more detailed and comprehensive financing framework at the second IDA15 meeting under the special theme of fragile states.^{2, 3}

2. In the past, the clearance of arrears has been handled on a case-by-case basis, in recognition of the different circumstances present in each country re-engaging with the Bank, and also of the collective action issues that affect processes involving multiple creditors. While the IDA countries now in arrears to IDA and IBRD do share some characteristics and circumstances, they also have important differences, for instance with respect to their economic and financial capacity, their level of indebtedness, and their eligibility for debt relief. These factors should impact how an arrears clearance package would be designed, including with respect to country payments. This, in turn, implies that while an approach to arrears clearance can be systematic, it would not lead to equal outcomes across countries. Rather, it would achieve equality of treatment through the consistent application of criteria that recognize the differences in specific country situations.

3. Since country situations change over time, and since the timing of arrears clearance cannot be precisely estimated, it is not possible to specify in advance exactly what each arrears clearance package would comprise. Moreover, in view of the collective action nature of debt workouts, the Bank's plans must be viewed in conjunction with the plans of other multilateral institutions on which the Bank's plans partly depend, in order to avoid negative outcomes such as reducing the total amount of debt relief available to countries eligible for exceptional arrears clearance support, jeopardizing the Bank's preferred creditor status, or increasing IDA's cost of debt relief. Thus, while this paper does provide estimates of the potential cost to IDA of providing exceptional support for arrears clearance in these countries, all such estimates assume *pari passu* treatment with other preferred creditors. These factors, i.e., different and evolving country circumstances, uncertainty about the timing of re-engagement, and the collective action issue, mean that

¹ See "Clearance of Arrears to IBRD and IDA: Further Considerations on Liberia and Future Cases", SecM2007-0036, January 29, 2007.

² The paper has been shared with other IMF and AfDB and has benefited from their comments.

³ A separate paper prepared for the second IDA15 meeting entitled "Operational Approaches and Financing in Fragile States" discusses additional aspects of IDA's support for fragile states.

the cost estimates provided in this paper should be regarded as indicative only and may change significantly as the actual arrears clearance packages are negotiated.

4. This paper is organized as follows. Section II provides updated information about the magnitude of the current arrears problem. Section III further elaborates on eligibility criteria for exceptional support and the principles and conditions for re-engagement. Section IV examines issues related to the provision of pre-arrears clearance grants. Section V provides an estimate of the cost of providing additional allocations for arrears clearance until the end of the IDA15 period. Section VI looks at how donors could finance the cost to IDA of providing exceptional support for arrears clearance. Section VII sets out issues for discussion.

5. The paper also attaches the HIPC Trust Fund Resolution, with proposed amendments that would allow it to receive contributions for arrears clearance and contributions to close the structural gap in the MDRI financing framework. Also attached is the form for use by HIPC donors to indicate their agreement to the proposed amendments.

II. Magnitude of Arrears Problem

6. **Arrears to IBRD and IDA:** Seven IDA countries have IDA credits in non-accrual status⁴ and three have IBRD loans in non-accrual status. The length of time that IBRD loans and IDA credits have been in non-accrual varies from 20 years for Liberia to less than three years in the case of Côte d'Ivoire. The average time that these countries have been accumulating arrears is 10 years. As of mid-May 2007, total arrears to IBRD and IDA amounted to US\$2.36 billion, of which three quarters is owed by four countries: Côte d'Ivoire, Liberia, Sudan and Zimbabwe. The amount in arrears is split almost evenly between IBRD and IDA. For this group of countries, arrears to IBRD are currently 73 percent of their total obligations to IBRD, reflecting the shorter maturities of IBRD loans. The corresponding figure for IDA is 18 percent, which reflects the long maturity of IDA credits.

⁴ Loans and credits are placed in non-accrual status when the oldest payment arrears are six months overdue – that is, when the second consecutive payment is missed on the loan/credits with the oldest arrears. In order to be eligible for new credits/grants, the country concerned must clear all payment arrears in full. Once all arrears are cleared, all loans/credits to, or guaranteed by, the country are generally restored to accrual status.

Table 1. Arrears to Preferred Creditors (US\$ million)

Country	Year of non-accrual	AfDB 1/			AsDB	IMF 2/	World Bank			Total
		Total	AfDB	AfDF			Total	IBRD	IDA	
Côte d'Ivoire	2004	466.1	454.5	11.6	0	0	448.8	330.0	118.8	914.9
Liberia	1987	195.3	187.8	7.5	0	801.6	473.1	421.0	52.1	1470.0
Myanmar	1998	0	0	0	228	0	233	0	233.0	461.0
Somalia	1991	63	15.5	47.5	0	352.6	161.6	0	161.6	577.2
Sudan	1994	178.5	109.3	69.2	0	1571.8	429.8	0	429.8	2180.1
Togo	2002	16.3	0	16.3	0	0	113	0	113.0	129.3
Zimbabwe	2000	350.1	345.0	5.2	0	127.8	496.2	416.2	80.0	974.1
Total		1269.3	1112	157.2	228	2853.9	2355.5	1167.2	1188.3	6706.7

Source: IMF, AfDB and AsDB, end March 2007. World Bank as of end May 2007.

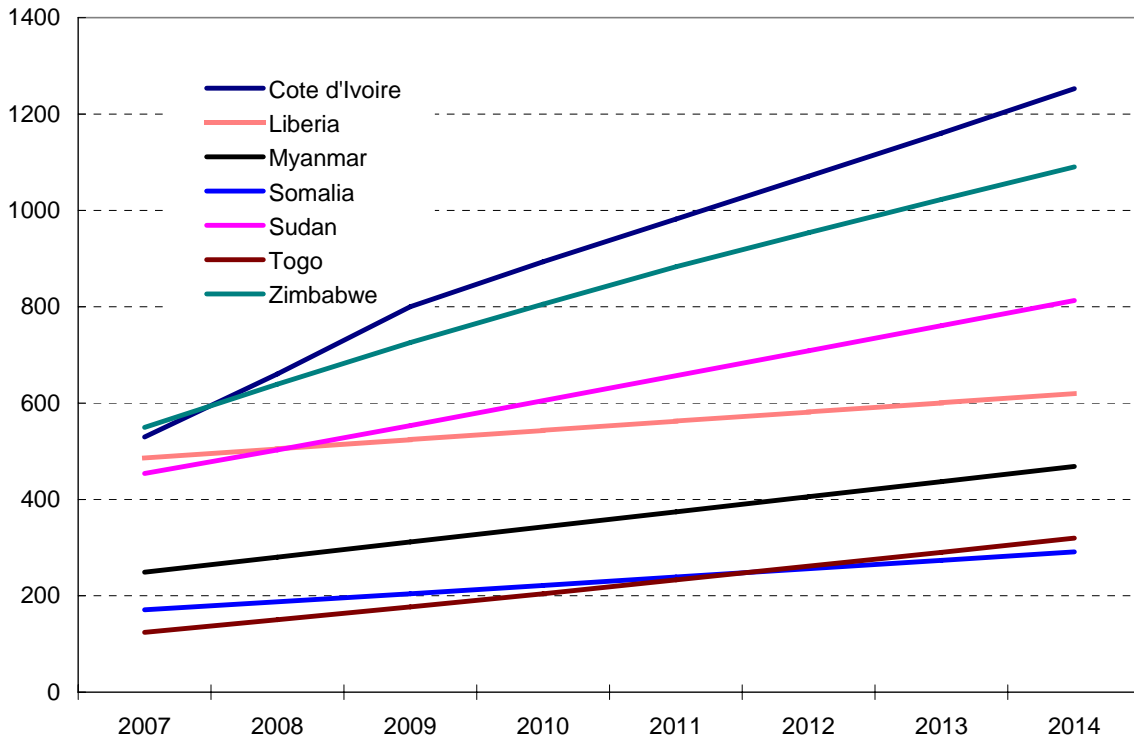
1/. Net of arrears to the Nigeria Trust Fund.

2/. Converted to US\$ at a rate of US\$1.51 per SDR on March 30, 2007.

7. **Rate of growth of arrears:** Unless payments are made, the size of the arrears is projected to grow, though the rate of growth tapers off once the bulk of principal payments are in arrears (since the World Bank does not charge interest on overdue interest). The aggregate rate of growth for IBRD and IDA arrears until the end of IDA15 (FY11) is about 11 percent. The rate then slows somewhat to 7 percent by the end of IDA16 in FY14. At an annual rate of 12 percent, arrears to IBRD grow faster than arrears to IDA during IDA15, but the IBRD rate of growth slows down to about 4 percent in IDA16 as principal payments due decrease. Because of IDA's longer maturities, arrears to IDA grow at a more even rate, averaging about 11 percent for the IDA15 and IDA16 periods. If both Côte d'Ivoire and Liberia clear arrears in FY08 as expected and remain on track with payments to IBRD and IDA afterwards, the stock of combined IBRD and IDA arrears would be reduced by about 40 percent in 2008.

8. On a country by country basis, those that have IBRD principal payments falling due tend to have faster growth of arrears. Thus the arrears of Côte d'Ivoire and Zimbabwe would be doubled by 2014. The average arrears growth rate in Côte d'Ivoire is about 17 percent during 2007-11 when IBRD principal payment are still falling due, and declines to about 8 percent from 2012 onwards when only IDA principal payments are due. Zimbabwe has a similar trend – the growth rate of the total arrears is 12 percent until IBRD obligations taper off in 2012, and then decreases to about 6 percent from 2012 onwards. Liberia on the other hand has all IBRD principal obligations in arrears and thus the arrears grow only at the rate of interest rates on the overdue principal. IDA debt can also contribute to a fast rise of arrears, especially in countries where the bulk of the debt is past the 10 year grace period, and the bulk of repayments of principal are at the 4 percent per annum rate. Sudan and Togo for instance, which only have IDA obligations falling due, have an average arrears growth rate of about 9 and 15 percent respectively during the 2007-2014 period.

Figure 1. Projection of cumulative financial obligations to IBRD/IDA (US\$ million) 1/



Source: Staff calculations based on World Bank Loan Client and Financial Services Group.
 Note: 1/ Assumes that countries continue to accumulate new arrears. The charge rate on IDA principals is 0.75 percent; interest on IBRD principals are computed with the following rates: 4.09 percent for Côte d'Ivoire, about 10 percent for Liberia and 8 percent for Zimbabwe.

9. **Share of IDA's outstanding obligations in arrears:** Over the past decade, the volume of IDA's credits in non-accrual status as a percentage of total IDA credits outstanding has ranged from 4 to 7 percent. As of end-June 2006, the non-accrual ratio was 4.7 percent. Due to the debt relief provided by IDA under the MDRI, which became effective as of July 1, 2006, the volume of IDA's outstanding credits has fallen by more than one quarter, lowering the denominator in the non-accrual ratio. As a result, IDA's non-accrual ratio has increased to 5.6 percent as of March 31, 2007, although the actual volume of credits in non-accrual status has fallen by some US\$300 million since June 30, 2006 due to the clearance of arrears by the Central African Republic in November 2006.

Table 2: Share of IDA credits in non-accrual status (US\$ million)

	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07 YTD
Total credits in non accrual status	4190	6067	5759	4763	4984	5940	5961	5662
Non-accruals as % of total credits	4.8%	7.0%	6.0%	4.5%	4.3%	4.9%	4.7%	5.6%
Credits disbursed and outstanding	86642	86572	96372	106877	115743	120907	127028	100362
Allowance for HIPC debt initiative	-8070	-8579	-10270	-10395	-10785	-11719	-45133	-12447
Credits disbursed and outstanding (net of debt relief)	78572	77993	86102	96482	104958	109188	81895	87915

10. **Arrears to other preferred creditors:** The seven IDA countries in arrears to IBRD and/or IDA are also in arrears to other preferred creditors (Table 1). Arrears to the African Development Bank (AfDB), the Asian Development Bank (AsDB), and the IMF amount to US\$4.4 billion as of end-March 2007. The bulk of this, US\$2.8 billion, is owed to the IMF by Liberia, Somalia, Sudan and Zimbabwe, with Sudan accounting for 55 percent of arrears to the IMF.⁵

11. **Total stock of arrears:** The total stock of arrears for these countries stood at US\$37.7 billion in 2006. Sudan's arrears account for 63 percent of the total. The IMF World Economic Outlook (WEO) forecasts that total stock of arrears⁶ in these countries will steadily increase in the medium-term (Table 3). As a share of GDP, the arrears burden in all countries except Togo tends to decrease in the medium-term based on optimistic GDP growth projections. Arrears as a share of exports decrease in countries with strong export projections like Côte d'Ivoire and Sudan, and increase substantially in Togo and Zimbabwe, where the volume of arrears is growing quickly and exports are declining fast.

Table 3. Total stock of arrears at year-end ^{1/}

	Volume (US\$ billion)		Arrears-to-GDP (%)		Arrears-to-exports (%)	
	2006	2011	2006	2011	2006	2011
Côte d'Ivoire	3.8	.	28.8	.	46.7	.
Liberia 2/	4.3	.	759.8	.	1985.8	.
Myanmar 3/4/	3.2	3.4	24.7	20.9	77.0	71.9
Somalia5/	2.6	.	.	.	972.6	.
Sudan 3/	23.7	32.2	63.0	49.1	390.8	183.2
Togo	0.4	1.0	18.4	27.9	50.4	82.6
Zimbabwe 3/	3.0	4.7	44.4	69.7	155.8	346.7

Source: IMF WEO, March 2007 and Bank staff estimates. Year corresponds to calendar year unless otherwise specified. Zimbabwe's GDP is from its DSA (2005).

Notes:

- 1/. In accordance with the IMF Balance of Payment manual the "total stock of arrears" encompasses public and private, and external and domestic arrears and "exports" refer to exports of goods and services..
- 2/. Data presented refer to arrears at end-June 2006 (Liberia: HIPC Preliminary Document, 2007).
- 3/. Data refers to total stock of public and publicly guaranteed external arrears.
- 4/. Year refers to fiscal year.
- 5/. Data refer to arrears at end-April 2007 (Bank staff estimates).

III. Eligibility Criteria and Principles and Conditions for Assistance

12. At the Paris meeting in March 2007, IDA Deputies requested additional information on both the criteria for eligibility for exceptional arrears clearance support, and the principles and conditions that would guide the process of re-engagement with countries in arrears. This section elaborates on these issues, as well as on factors that mitigate the risks associated with the systematic approach.

⁵ The IMF (2007), "Update on the Financing of the Fund's Concessional Assistance and Debt Relief to Low-Income Member Countries," p. 12, April.

⁶ Total stock of arrears encompasses public and private, and external and domestic arrears, and exports do exports of goods and services, in accordance with the IMF Balance of Payment manual.

13. At the outset it should be noted that re-engagement with an IDA country in arrears has in the past not been an automatic process, but rather a carefully sequenced series of events grounded in Bank policies, the judgment of Bank management, and consultations with, and formal approval of each specific operation by, the Executive Directors. The discussion of “re-engagement” in this paper refers to the process through which IBRD and IDA resume normal financial relations with a country in arrears.⁷ For the purposes of this paper, the term “normal financial relations” refers to the requirement that member countries are current on their obligations to IBRD and IDA, which in turn enables member countries to access regular financial assistance in accordance with existing Bank policy.

14. Eligibility criteria for exceptional support for arrears clearance are described in Section A below. It should be noted, however, that a country which meets the eligibility criteria in Section A does not automatically qualify either for initiation of the IDA re-engagement process or for access to IDA resources in support of arrears clearance. Rather, the country must also satisfy various additional requirements for the initiation of the re-engagement process, including with respect to overall eligibility for IDA resources, conditions for resumption of regular assistance from IDA, and specific conditions for arrears clearance operations. Those requirements and conditions are discussed in section B below.

A. Eligibility for Exceptional Arrears Clearance Support

15. Management’s proposal in the February 8, 2007 paper was to ring-fence eligibility for exceptional arrears clearance support to IDA countries that were in arrears as of December 31st, 2006, and grandfathered for eligibility under the HIPC Initiative but that have yet to reach the HIPC decision point.^{8, 9} As noted in that paper, a significant benefit of an arrears clearance program for the pre-HIPC decision point countries is its potential to contribute to the completion of the debt relief process for these countries. Furthermore, arrears clearance is also central to the debt relief process for these countries; without clearance of arrears to multilateral institutions the HIPC process cannot commence. The previous paper also noted that the eligibility criteria for exceptional arrears clearance support would exclude two countries – Myanmar and Zimbabwe – which were not grandfathered under the HIPC Initiative, but also Management’s view that these countries

⁷ With the exception of pre-arrears clearance grants, IDA does not provide financial assistance to countries with loans or credits in non-accrual status. IDA can, however, provide limited financial assistance to those countries in the form of grants from the LICUS Trust Fund or the Post-Conflict Fund as well as analytic and technical support from the Bank’s administrative budget. The provision of pre-arrears clearance grants forms part of the re-engagement process and is discussed separately in Section IV of this paper.

⁸ In August 2006, the Executive Directors decided to let the HIPC Initiative sunset clause take effect and grandfather the countries assessed to have met the Initiative’s income and indebtedness criteria based on end-2004 data. Only the grandfathered countries could qualify for HIPC Initiative debt relief in the future. See “Heavily Indebted Poor Countries (HIPC) Initiative – List of Ring-Fenced Countries that Meet the Income and Indebtedness Criteria at end-2004,” April 12, 2006, IDA/R2006-0041/2, and “Heavily Indebted Poor Countries (HIPC) Initiative – Issues Related to the Sunset Clause,” August 18, 2006, IDA/R2006-0175. This document presents a list of countries grandfathered for HIPC eligibility which can be amended to include countries that are subsequently assessed to meet the HIPC Initiative income and indebtedness criteria based on end-2004 data.

⁹ World Bank (2007), *op. cit.*, p. 17.

could be subsequently grandfathered for HIPC eligibility provided they are assessed to meet the HIPC Initiative income and indebtedness criteria based on end-2004 data. Below is a short synopsis of where these two countries stand with respect to the HIPC Initiative.

- **Myanmar:** Myanmar was not grandfathered for qualification under the HIPC Initiative because Bank staff did not have the data needed to assess its indebtedness level relative to the HIPC Initiative thresholds.¹⁰ The latest staff estimates suggest that, as of end-December 2004, Myanmar's NPV of debt-to-exports ratio, at 149.9 percent, is slightly below the HIPC Initiative threshold.¹¹¹² A new assessment for Myanmar will be undertaken once adequate debt data for the exercise is provided by the authorities. As pointed out previously, Myanmar's arrears to IDA are of a more manageable size relative to a likely re-engagement allocation from IDA, and hence the need for exceptional support for arrears clearance appears lower than for the other countries for the time being.
- **Zimbabwe:** Zimbabwe was not grandfathered for eligibility under the HIPC Initiative, since as at end-2004 it was not an IDA-only and PRGF-eligible country and thus did not meet the Initiative's income criterion. Since that time the economic situation in Zimbabwe has significantly worsened. Should Zimbabwe be assessed to meet the HIPC Initiative indebtedness criterion based on end-2004 data, it could be possible that IDA's Executive Directors decide at some time in the future to include Zimbabwe in the list of countries grandfathered under the HIPC Initiative, if deemed appropriate.¹³ This step would be necessary in order for Zimbabwe to be able to access exceptional support for arrears clearance. In view of Zimbabwe's limited payment capacity, and the fact that its likely IDA allocation may only be sufficient to cover 13 percent of the amount currently in arrears to IBRD and IDA, Zimbabwe may require substantial exceptional support for arrears clearance.

¹⁰ In a letter dated January 24, 2006, the Governor of the Central Bank of Myanmar regretted that "they will not be able" to provide the data required to undertake the assessment.

¹¹ For the latest staff estimates please refer to "Heavily Indebted Poor Countries (HIPC) Initiative: Status of Implementation," August 22, 2005, IDA/SecM2005-0442.

¹² Staff estimates suggest that Myanmar cannot access HIPC debt relief through the revenue window as its revenue to GDP ratio is below the required level.

¹³ Grandfathering Zimbabwe for HIPC eligibility would need the approval of IDA's Executive Directors for a modification of, or exception to, the Bank's HIPC Initiative's eligibility criteria. For IDA, both the income and indebtedness criteria are bound by the end-2004 cut-off. Hence, in the case of the Bank, countries that become IDA-only and PRGF-eligible after end-2004 would not be automatically added to the list of grandfathered countries even if they meet the HIPC Initiative indebtedness criterion based on end-2004 data. For the Fund, the income criterion is not bound by the end-2004 cut-off. Consequently, countries that become IDA-only and PRGF-eligible after 2004 and meet the HIPC indebtedness criterion based on end-2004 data would automatically be added to the list of countries grandfathered for HIPC eligibility.

B. Policies that Apply to Re-engagement

16. The policies and conditions that apply to re-engagement fall into three separate categories: (i) those that apply to a country's overall eligibility for IDA resources; (ii) the policies and practices that bear on the decision to re-engage and resume financial assistance in a member country; and (iii) the specific conditions for an arrears clearance operation.

17. **IDA eligibility criteria:** Most broadly, each country eligible for exceptional arrears clearance support would need to continue to meet IDA eligibility criteria, that is, they would need to meet the standard poverty, creditworthiness and performance tests for IDA support. Thus per capita income should be below IDA's income cut-off (currently US\$1,025), the country should lack creditworthiness for IBRD lending¹⁴ and should be deemed able to use IDA resources effectively.¹⁵

18. Of these criteria, the performance criterion is the most relevant in terms of establishing whether IDA should proceed towards re-engagement, in part because a focus on performance also helps offset the built-in moral hazard of debt cancellations and concessional arrears clearance. While macro-economic stability would be an important standard of performance, it is clear that in the case of the countries in arrears IDA resources may be needed for the formulation and implementation of reforms. In line with the current practice of adjusting the performance test based on the circumstances prevailing in IDA countries, it would thus be more appropriate that the case for IDA resources be made on the basis of government commitment to a reform-oriented social and economic recovery program, as well as prior actions.¹⁶ This criterion, while recognizing the difficult circumstances of a country confronting arrears, would also allow IDA to delay re-engagement until such time as a country was deemed able to use IDA resources effectively.

19. **IDA re-engagement criteria:** The Bank does not have an explicit policy that guides IDA re-engagement in member countries. Rather, the decision to re-engage is made based on the facts and circumstances of each case. This decision is made within the context of IDA's legal and policy framework, which includes the Articles of Agreement and relevant provisions of various operational policies and procedures, as informed by operational and institutional practice. More specifically, a decision whether to re-engage is made within the following parameters.

- Applicable provisions of IDA's Articles, notably IDA's purposes (Article I); terms of financing (Article V (2)); cooperation with other international organizations (Article V (4)); and the prohibition on political activity (Article V (6));
- For countries emerging from conflict – which includes four of the IDA countries in arrears – the policy framework articulated in Operational Policy (“OP”) 2.30 (*Development Cooperation and Conflict*), and its accompanying

¹⁴ Defined as “the ability to service new external debt at market interest rates over the long term” IDA - Eligibility, Terms and Graduation Policies IDA/SecM2001-0004, paragraph 10.

¹⁵ IDA/SecM2001-0004, *op. cit.* para 14.

¹⁶ IDA/SecM2001-0004, *op. cit.* para 15.

statement of Bank Procedures (“BP”) 2.30 would apply. The policy framework under OP 2.30 contains various principles for the Bank’s involvement in conflict-affected areas.¹⁷ Certain elements of that framework could also provide useful guidance for the Bank to re-engage in countries in arrears that have not been heavily impacted by conflict, such as Myanmar, Togo and Zimbabwe.¹⁸

- Where applicable, OP 7.30 (*Dealings with De Facto Governments*), which provides guidance for Bank staff with respect to existing loans in a country portfolio (if one exists in a given situation) and new operations in a country after the emergence of a *de facto* government.¹⁹
- The Bank’s financial policies and its preferred creditor status.²⁰
- The Bank’s operational and institutional practice in providing assistance to post-conflict areas or fragile states, and emergency situations. Evidence of the Bank’s practice can be drawn from specific projects or operations in these areas as well as through CAS-type documents (such as interim strategy notes, country reengagement notes, and transitional support strategies).²¹

20. With respect to operational and institutional practice, Board discussions on engagement in fragile states in the context of the LICUS initiative have stressed the importance of a clear recovery program, which can provide: more measurable evidence of efforts to sustain a peace or transition process; coordinated international support; and an appropriate division of labor between the Bank and other international partners. Before IDA re-engagement, the Bank would hence normally look for the presence of a transition or recovery plan, supported by national and international actors and covering key

¹⁷ Some of the principles in OP 2.30 are derived from the Articles themselves. See Senior Vice President and Group General Counsel, *Legal Opinion on Peace-Building, Security, and Relief Issues under the Bank’s Policy Framework for Rapid Response to Crises and Emergencies* (March 22, 2007) at paragraph 10. It should also be noted that OP 2.30 recognizes the possibility of exceptional financial assistance for conflict-affected countries to meet their transitional needs. According to the policy, such assistance may be provided, subject to Board approval, if it is: (i) consistent with the Bank’s financial policies and its preferred creditor status; and (ii) consistent with burden-sharing principles. See OP 2.30 at paragraph 11.

¹⁸ Elements from the policy framework in OP 2.30 that could apply would include: (i) a reasonable expectation of continued stability; (ii) the presence of an effective counterpart for the Bank; and (iii) the evidence of strong international cooperation and the potential for a well-defined role for the Bank. See OP 2.30 at paragraph 9.

¹⁹ According to OP 7.30, a government is “de facto” if it comes into, or remains in, power “by means not provided for in the country’s constitution, such as a coup d’état, revolution, usurpation, abrogation, or suspension of the constitution.”

²⁰ Applicable policies include OP 3.10 (Financial Terms and Conditions of IBRD Loans, IBRD Hedging Products, and IDA Credits); OP 6.00 (Bank Financing); OP 8.60 (Development Policy Lending) and OP 13.40 (Suspension of Disbursements). The preferred creditor status refers to the practice of Bank borrowers continuing to service their loans from IDA and IBRD during periods when they are unable to service all their external debts in accordance with their terms.

²¹ The Executive Directors have been involved in all of these cases. The Board has approved specific proposals for operations, discussed Interim Strategy Notes (ISNs), Country Re-engagement Notes (CRNs), and Transitional Support Strategies (TSSs), and considered various papers, reports, and updates regarding Bank engagement in these areas as a consequence of the Low Income Countries Under Stress (“LICUS”) and Fragile States initiative.

challenges in the peace or national reconciliation, rule of law, and economic and social areas, including provisions to address risks of deterioration in peace and security.

21. Such a recovery program with multi-donor support should also include a comprehensive debt resolution strategy. Assurance would have to be obtained that the country would normalize its relationship with other creditors and embark upon a path towards reaching HIPC decision point. Conditions for the HIPC decision point include arrears clearance, an I-PRSP and a track record of solid macro-economic performance.

22. **Conditions for Assistance:** The resumption of regular IDA assistance to a member country as a consequence of the Bank's decision to re-engage in that country is usually based on the formulation of a re-engagement strategy.²² A key part of such a re-engagement strategy would be a plan for normalization of relations and clearance of arrears, developed in cooperation with the other preferred creditors. Such a plan would follow the broad principles of an approach adopted by the Bank's Executive Directors in 1991 to facilitate the workout of arrears.²³ While important developments have taken place since this policy was adopted, such as introduction of the HIPC and MDRI initiatives, the core principles of this policy are still sound. The Bank would work closely with countries with large and protracted arrears during a pre-arrears clearance "performance period" designed to establish a track record on reform measures, allow the Bank to undertake an intense policy dialogue with the country, and to develop new operations. The borrower would need to meet three key conditions:

- (i) the borrower must agree to, and implement, a medium-term growth-oriented reform program endorsed by the Bank;
- (ii) the borrower would undertake, if needed, a stabilization program endorsed by Fund Management and monitored by IMF staff or supported by a Fund arrangement. Satisfactory performance under such program would inform the Bank's decision to proceed with policy-based financing where such financing is required;²⁴ and,
- (iii) a financing plan must be agreed which provides for the full clearance of arrears to the Bank in the context of the medium-term reform program, and for the normalization of relations with other multilateral institutions where there are also arrears to those institutions. When a borrower has arrears to several IFIs, the preferred approach is for those arrears to be cleared simultaneously. However, a sequential arrears clearance approach may be pursued on a pragmatic case-by-case basis by mutual agreement among IFIs.

²² For instance, the Bank prepares an ISN to develop a program of assistance for country emerging from conflict (if the country has no CAS or is the CAS no longer represents a responsive strategy. See OP 2.30 at paragraph 8.

²³ "Report on Bank Policies and Practices with Respect to Countries in Arrears", Joint Audit Committee, R90-205, October 22, 1990, and "Additional Support for Workout Programs in Countries with Protracted Arrears" R91-70, April 11, 1991. The policy adopted in 1991 was reviewed and endorsed by the Joint Audit Committee in April 1993.

²⁴ Typically such a track record has been established through two successful reviews under an IMF arrangement or IMF-monitored program.

23. Furthermore, the financing plan should ensure the sustainability of debt service up until the HIPC decision point (to mitigate the risk of relapse into arrears), and should aim to provide at least non-negative net transfers from each creditor, to ensure that positive net flows from IDA are used for reconstruction, and not to pay other creditors. It is important to note that IDA would not agree to proceed with exceptional assistance for arrears clearance unless it received *pari passu* treatment with other creditors.

24. The principles outlined above are also included in the HIPC Initiative, which requires that arrears to multilateral creditors must be cleared, or an agreement be reached for their clearance, before a country reaches its HIPC decision point.²⁵ This requirement is part of the policy track record that HIPCs need to establish under an IMF upper tranche conditionality arrangement (normally a PRGF²⁶) to be eligible for consideration of its decision point by the IMF.²⁷

25. As part of the arrears clearance strategy, the Bank would also prepare a specific operation to facilitate the clearance of arrears. For the current set of countries in arrears the Bank would most likely rely on the “bridge-loan” mechanism, a solution which has been used in the past to address similar situations. IBRD and IDA arrears would be cleared through a “bridge loan” equal in size to the total arrears owed to IBRD and IDA. The bridge loan, of a maximum overnight duration, would need to be provided (or guaranteed) by a donor. The provider of the bridge loan would be repaid from the proceeds of an IDA-financed development policy operation (DPO) which would be at least equal in size to the arrears outstanding. Per the stipulations of IDA’s grant allocation system it is likely that most if not all such operations would be provided on a 100 percent grant basis in view of the high risk of debt distress of these countries.

26. Consistent with the Bank’s operational policy for development policy lending, to be eligible for policy-based financing (including operations to repay bridge loans for arrears clearance) each country would need to have in place an appropriate macroeconomic policy framework that is based on the prevailing circumstances in each case.²⁸

²⁵ Arrears towards Paris Club creditors are usually rescheduled under Naples terms at the beginning of the IMF arrangement leading to the HIPC decision point. With respect to non-Paris Club and commercial creditors, the debtor country is expected to exert its best efforts to obtain terms comparable to those granted by the Paris Club.

²⁶ Under the Fund’s HIPC Trust Instrument the required track record leading to decision point can be provided by performance under programs supported by the Fund through PRGF, a RAP, or, on a case-by-case basis other Fund arrangements such as an EPCA.

²⁷ Fund arrangements include specific performance criteria on the elimination or reduction of existing arrears and the non-accumulation of new external arrears during the period of the arrangement.

²⁸ The presence of an appropriate IMF program is usually an important input in determining whether there is an appropriate macroeconomic policy framework. If there is no Fund arrangement, Bank staff ascertain, before making their own assessment, whether the Fund has any major outstanding concerns. Any outstanding issues related to the adequacy of the macroeconomic policy framework raised by the IMF are communicated to Executive Directors. Under current practice, IMF views are communicated in the form of a recent public information notice, Chairman’s statement, or IMF assessment letter.

C. Risk Mitigation Factors

27. While ring-fenced eligibility and the Bank's strong policies and conditions for re-engagement mitigate the risks inherent in the provision of exceptional support for arrears clearance, there is nonetheless a possibility that there could be a signaling effect from such an approach, i.e., that it could provide an incentive for other IDA borrowers to stop servicing their obligations to IDA. As previously indicated, Management believes this risk is effectively mitigated by a number of factors and preventive measures, including recent IDA policies relating to grants, debt relief and non-concessional borrowing.

- First, entry into non-accrual status tends to be symptomatic of larger problems that IDA countries may confront, including conflict and political crises. Since most IDA countries have net positive transfers from IDA, it would not make financial sense for a country to go into non-accrual status even if arrears would be cancelled as the country re-engaged with IDA. Not only would the country have forfeited its annual IDA allocations in the arrears period, it might also be required to finance arrears clearance from its re-engagement allocation. Furthermore, disbursements from existing credits would be suspended, and these credits would also be cancelled in due course.
- Second, in addition to being carefully ring-fenced, eligibility for exceptional arrears clearance support is determined through the IDA replenishment process, and it is also through this process that the level of financing is determined. Since replenishment outcomes are uncertain, a country would incur a very significant risk if it were to stop debt service to the Bank on the premise that the necessary exceptions with regards to eligibility and allocation rules would be made in a manner that would be financially advantageous.
- Third, almost all of the high credit risk countries in the IDA-only group either have received, or are eligible to receive, deep debt relief and forgiveness through the HIPC and MDRI initiatives. Thus going forward, their debt payments, if any, are likely to be small relative to the size of the IDA allocations that they would qualify for. Hence, if one of these countries relapsed into arrears it should be able to clear its own arrears.
- Fourth, the IDA14 grant allocation system slows debt re-accumulation for high credit risk countries. Because IDA now determines grant eligibility based on Debt Sustainability Analyses (DSAs) there is also a strong system in place for picking up signals about the risk of debt distress, which will allow IDA to adjust its terms, which in turn reduces the possibility of arrears episodes.
- Fifth, IDA's non-concessional borrowing policy may help prevent the rapid re-accumulation of debt in re-engaging countries. The policy adopts a two-pronged approach: (i) coordination with other creditors on financing terms of loans to grant or debt relief recipients on the basis of a country-specific DSA, and (ii) the potential to apply disincentive measures to borrowers in the event they draw non-concessional loans. These measures should help ensure that borrowing is carried out at a pace consistent with countries' debt carrying capacity.

IV. Proposed Modification to IDA's policy on Pre-Arrears Clearance Grants

28. Pre-arrears clearance grants were first authorized for post-conflict countries with large and protracted arrears in IDA12, but only as a last resort where other funding sources are inadequate and where the use of IDA credits would be inappropriate.²⁹ Such grants enable IDA to engage earlier with countries that are in the process of emerging from conflict without compromising the financial policies that prevent lending to countries in arrears.

29. IDA pre-arrears clearance grants have been provided to three countries in arrears that have recently re-engaged with IDA. Issues regarding the use of such grants in Liberia were raised by Deputies at the Paris meeting. That, as well as issues around potential pre-arrears clearance grants for Côte d'Ivoire and Liberia, suggest that the conditions for providing such grants require closer examination.

30. The IDA12 report stipulated that the use of grants before arrears clearance should be guided by a framework for [the provision of pre-arrears clearance grants to] post-conflict countries approved by the Executive Directors. Such a framework was established when the first IDA pre-arrears clearance grant – for the Democratic Republic of Congo (DRC) in the amount of US\$50 million – was approved in July of 2001.³⁰ The five conditions constituting this framework are set out in the project document and include that:

- (i) the proposed grant has been designed in accordance with OP 2.30;
- (ii) early performance is promising as evidenced by the recipient country having taken convincing steps towards social and economic recovery;
- (iii) arrears to IBRD and/or IDA are large and protracted, and cannot be easily or quickly cleared using domestic resources;
- (iv) a concerted international effort to provide positive financial flows and other assistance is underway, and other creditors have agreed not to make net withdrawals of financial resources from the country; and
- (v) alternative sources of financing for post-conflict recovery are inadequate or available only on inappropriate terms.

31. The authority to provide pre-arrears clearance grants was continued unchanged in IDA13, and again in IDA14, where it constitutes one of two exceptions to the general rule of allocating IDA grants in accordance with countries' risk of debt distress. The IDA14 Replenishment Report stipulates that "use of these [pre-arrears clearance] grants is expected to be very limited, and must comply with the policy framework approved by IDA's Executive Directors in July 2001 for the provision of these grants".³¹

²⁹ See "Additions to IDA resources: Twelfth Replenishment", January 12, 1999, paragraphs 38 and 44.

³⁰ DRC: Emergency Early Recovery Project. July 9, 2001. Report No: P 7469 ZR.

³¹ See "Additions to IDA Resources: Fourteenth Replenishment, March 10, 2005, Annex 1, footnote 67.

32. In addition to the five conditions approved in the framework, in order to be eligible for a pre-arrears clearance grant, a country would first have to qualify for exceptional post-conflict allocations as per the allocation methodology approved as part of the IDA13 replenishment in 2002.³² Furthermore, while there are no specific guidelines for determining the size of pre-arrears clearance grants, the IDA12 report suggests that these grants are meant to be small.³³ This point is also reflected in the initial IDA13 paper on the IDA post-conflict allocation methodology which suggests that “the size of the grant should not reduce incentives for an orderly and expeditious clearance of arrears”.³⁴ That paper, and the shorter version incorporated as Annex 2 in the IDA13 report, states that the post-conflict allocation methodology should be used as an “input to the determination of the size of pre-arrears clearance grants”.³⁵

33. To date, two countries besides DRC have benefited from pre-arrears clearance grants: Afghanistan (2002) and Liberia (2006). In terms of allocations, DRC and Afghanistan received US\$1 and US\$4 per capita, respectively. In both cases the allocation was substantially smaller than what each country received as annual allocations once arrears were cleared. In DRC, the US\$50 million grant allocation was used to finance one operation; in Afghanistan, the US\$100 million allocation was spread over four operations. Liberia received its first US\$30 million (about US\$8.6 per capita) pre-arrears clearance grant in June 2006. Because of delays in the process of clearing Liberia’s arrears, a subsequent grant of US\$16.5 million was provided in October 2006 from its notional FY07 IDA allocation.

34. While the experience to date with pre-arrears clearance grants has been positive, and they have been shown to be a useful addition to regular IDA instruments, the current policy guidance on these grants need to be amended in three respects.

35. First, the Liberia example suggests that some countries will not be able to clear arrears in a timely fashion, not because their own performance is lagging, but rather because of the time it can take for multilateral institutions to mobilize the financing necessary to back a comprehensive arrears clearance plan. Management’s view is that in such cases, IDA ought to be able to provide additional pre-arrears clearance grants up to the amount of the expected annual IDA allocation for a post-conflict country eligible for pre-arrears clearance grants.³⁶ Management has thus submitted two additional pre-arrears clearance grants for Liberia, totaling US\$13.5 million, for Board consideration in mid-June 2007.³⁷ A grant for the third year amounting to US\$37 million is also ready for Board consideration in July 2007. The year in which such additional grants would be provided would constitute part of the period of exceptional allocations under IDA’s rules for

³² See “Additions to IDA Resources: Thirteenth Replenishment”, July 12, 2002. Annex 2.

³³ IDA (1999), *op. cit.* para. 38.

³⁴ See “Adapting IDA’s Performance-Based Allocations to Post-Conflict Countries”. IDA13 paper, May 2001.

³⁵ See “Additions to IDA Resources: Thirteenth Replenishment”, July 12, 2002. Annex 2, footnote 54.

³⁶ Management notes that in cases like Côte d’Ivoire where the authorities have committed to an arrears clearance plan it would not be possible to get more than one pre-arrears clearance grant. Otherwise IDA could be seen to “reward” the failure to implement the plan with a series of pre-arrears clearance grants.

³⁷ These two grants would be financed from the remainder of Liberia’s notional FY07 IDA allocation of US\$35 million. FY07 would count as the first year of the period for providing exceptional IDA post-conflict allocations to Liberia.

providing exceptional post-conflict allocations. This would avoid creating an incentive for countries to delay arrears clearance.

36. While extending the use of pre-arrears clearance grants would help ensure that countries receive the resources they need to finance recovery efforts, the delays in arrears clearance nonetheless have important consequences for IDA. Delays resulting from the absence of financing for other multilateral creditors could possibly increase the cost to IDA of the systematic approach since arrears would continue to grow. Furthermore, to the extent that this increase in the size of the arrears would be financed under the systematic approach, this would represent a further frontloading of HIPC debt relief (see paragraph 62 below for a fuller explanation of this point).

37. Second, condition (iv) in the framework approved by the Executive Directors (see paragraph 30), which requires all creditors to allow arrears to accumulate, has not proven to be an effective condition. In the case of the Democratic Republic of Congo (DRC), this condition created an impasse with the IMF, because of their requirement that countries establish a track record of payments with the IMF as part of the arrears clearance process. To protect their preferred creditor status, this requirement triggered calls from other multilateral creditors as well. The issue was resolved by a compromise whereby DRC would make deposits into an account they controlled with the Bank for International Settlements (BIS). The resources were apportioned *pari passu* to the IMF, AfDB and the Bank (according to the size of their arrears), but remained part of DRC's foreign exchange reserves. Since DRC would need to maintain foreign exchange reserves under any circumstances, the Bank's Board agreed that this arrangement met the spirit of condition (iv), i.e., it did not reduce the amount of resources available for reconstruction, nor did it jeopardize the Bank's preferred creditor status.

38. In the case of Liberia, the IMF did not agree to either eliminate payments, or to the compromise reached in the DRC case.³⁸ In order not to hold up much needed development financing for Liberia, the Bank's Board agreed to waive the condition, with the proviso that Liberia ensured *pari passu* treatment of the three preferred creditors (i.e., made small payments in proportion to the size of each creditor's arrears).³⁹

39. The issue is arising again in the case of Côte d'Ivoire, where the Bank is preparing an operation on a pre-arrears clearance grant basis for Board presentation in July 2007. Côte d'Ivoire currently has the capacity to pay some, but not all of its arrears to IBRD and IDA, and it is expected that preparing the ground for an arrears clearance operation will take at least six months. In the meantime, the Bank has prepared an operation that is critical to moving the peace and reconciliation process forward in Côte d'Ivoire and that is also a condition for an IMF Emergency Post-Conflict Assistance (EPCA) operation.⁴⁰ To enable this critical operation to proceed, Management will propose to the Board that it

³⁸ Under the Fund's policy, payments are a necessary part of the test of cooperation under a strengthened cooperative strategy. The Fund's position on Liberia was predicated on the facts that unlike in DRC, which was just starting to make payments, Liberia had already been making monthly payments to the Fund for some time; (b) the time frame for arrears clearance was uncertain and potentially much longer; and (c) a RAP was envisaged for Liberia, which has certain payment requirements.

³⁹ See Liberia: Emergency Infrastructure Project. June 20, 2006. Report No: P100160.

⁴⁰ Côte d'Ivoire is current on its obligations with the Fund.

approve the operation on a pre-arrears clearance grant basis, while requiring Côte d'Ivoire to begin to service its debt to IBRD and IDA for the interim period between approval of the grant and full arrears clearance. Côte d'Ivoire is already servicing its debts to the IMF, and will also begin to service its debts to AfDB.

40. Third, eligibility for pre-arrears clearance grants has been restricted to countries eligible for exceptional post-conflict allocations from IDA. This practice is likely to exclude several of the countries that could be eligible for support for arrears clearance, i.e. those that would only qualify under IDA's re-engagement exception. However, these countries face many of the same challenges that countries emerging from conflict face as they begin the process of post-crisis recovery. IDA would not be able to respond to these challenges with new resources until arrears were cleared, which could be a time-consuming process.

41. Going forward, following discussion with Deputies, Management would propose to the Executive Directors that:

- (a) IDA would be able to provide additional pre-arrears clearance grants to countries where arrears clearance is delayed for reasons unrelated to a country's track record.⁴¹ The years in which such additional grants would be provided would constitute part of the period of exceptional allocations under IDA's rules for providing exceptional post-conflict allocations;
- (b) condition (iv) of the pre-arrears clearance grant framework should be implemented flexibly, taking account of specific country circumstances while fully protecting preferred creditor status of IBRD and IDA and full *pari passu* treatment with other multilateral institutions; and
- (c) re-engaging countries eligible for exceptional support for arrears clearance could also be eligible for pre-arrears clearance grants. This latter proposal would extend eligibility to Myanmar, Togo and Zimbabwe.

42. As in the past, all pre-arrears clearance grants will be presented to the Board for discussion and approval.

V. Cost Estimates for Arrears Clearance

43. The factors that determine the cost of each arrears clearance exercise cannot be precisely estimated in advance. These factors include: (i) the timing of arrears clearance, (ii) country capacity to finance arrears clearance, and (iii) the requirements of other creditors. These factors are discussed below, as is the process by which Bank staff would approach the task of determining the share of the arrears that should be covered from country resources. Lastly, this section provides an estimate of the costs of providing exceptional support for arrears clearance in IDA15.

⁴¹ Additional pre-arrears clearance grants would not be available to a country that was performing under its reform program but that wanted to delay financing its share of an arrears clearance program.

44. **Timing of arrears clearance:** Table 4 shows current estimates for the timing of arrears clearance for the HIPC-eligible countries in arrears, as well as their estimated HIPC decision and completion points.⁴² These dates have been revised from the 2006 HIPC costing exercise, to reflect recent developments on country progress under or towards IMF-supported programs. The assumed dates for arrears clearance for Myanmar and Zimbabwe are based on country team assessments and are highly speculative. It is important to note that the actual arrears clearance dates, as well as the decision and completion point dates may be different than the ones assumed below. With respect to arrears clearance it is assumed that Côte d’Ivoire and Liberia will be able to clear arrears in FY08, and Togo in FY09, Zimbabwe in FY10 and Sudan in FY11.⁴³ Myanmar and Somalia are not expected to clear arrears during the IDA15 period (FY09-11).

Table 4. Indicative dates for arrears clearance, and HIPC DP and CP ⁴⁴

	Arrears clearance	Decision Point	Completion Point
Côte d’Ivoire	FY08 (IDA14)	FY09	FY11
Liberia	FY08 (IDA14)	FY08	FY10
Myanmar (estimate)	IDA16	n.a.	n.a.
Somalia (estimate)	IDA16	FY14	FY17
Sudan (estimate)	FY10 (IDA15)	FY10	FY13
Togo (estimate)	FY09 (IDA15)	FY09	FY11
Zimbabwe (estimate)	FY11 (IDA15)	n.a.	n.a.

45. **Country capacity to finance arrears clearance:** Countries in arrears are all experiencing some form of crisis, ranging from violent conflict to serious governance problems and political paralysis. Typically, these crises are of long duration, which in turn explains why overall macroeconomic performance for the countries in arrears is worse than for IDA countries that are current on their obligations. Inflation tends to be far higher, and the external debt and fiscal balance ratios tend to be worse. IMF assessments of macroeconomic policies also show worse results for instance on fiscal policy, composition of public spending, monetary policy, consistency of macro policies, transparency of monetary and fiscal institutions, and exchange rate regime.

46. While these indicators would suggest overall limitations on capacity to pay, the macroeconomic situations of countries in arrears do vary (Table 5). For instance, the per

⁴² See “Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI). Status of Implementation” IDA/SecM2006-0455, August 25, 2006.

⁴³ Note that for the purpose of determining the cost of exceptional support for arrears clearance (Table 8), Sudan and Zimbabwe are assigned a 50 percent likelihood of clearing arrears during the IDA15 period (FY09-11).

⁴⁴ The timing of arrears clearance is difficult to estimate with precision because of the inherent uncertainty around country re-engagement, and the fact that the arrears clearance process itself can be time-consuming as demonstrated in the case of Liberia. These estimates are thus highly indicative, and somewhat more conservative than those used in the HIPC context to estimate the timing of HIPC decision and completion points

capita income levels of Côte d'Ivoire and Sudan, at US\$840 and US\$640 respectively, are about double Togo's and Zimbabwe's, which are US\$350 and US\$340, respectively. Income per capita of Liberia in 2005 is only US\$130. Côte d'Ivoire has international reserves equivalent to about 3 months of imports in 2006 or equivalent to 54 percent of total arrears, while Liberia's reserves are merely about one percent of its total arrears. Furthermore, while all of the countries are highly indebted, the level of indebtedness varies: NPV of debt-to-GDP ratios range from 61 percent (Côte d'Ivoire) to 767 percent (Liberia) in 2006; NPV of debt-to-exports ratios from 137 percent (Côte d'Ivoire) to 3069 percent (Liberia). Per capita arrears for Côte d'Ivoire, Myanmar, and Togo are far lower than for Liberia and Sudan which have total arrears per capita of US\$711 and US\$686, respectively. Lastly per capita arrears to the World Bank vary from US\$ 4 to US\$ 143.

Table 5. Debt and arrears indicators (2006)

Country	GNI per capita (Atlas method, 2005 US\$) a/	NPV of debt-to-exports (%) b/	International reserves (% of total arrears) c/	Total arrears per capita (US\$) d/	WB arrears per capita (US\$) e/
Cote d'Ivoire	840	137	54	164	24
Liberia	130	1985.8	1	711	144
Myanmar	N/A	..	41	57	4
Somalia	226	1124	..	342	21
Sudan	640	690	15	686	12
Togo	350	199	76	73	20
Zimbabwe	340	252	3	254	42

Sources:

- a/. WDI and World Bank staff estimate for Somalia (2003).
- b/. Various. Côte d'Ivoire – the numerator refers to 2005 (GDF), the denominator to 2003-5 average (WEO), Liberia HIPC Preliminary Document (2007), Zimbabwe: 2005 Article IV Consultation (IMF); Somalia: World Bank staff estimates – the numerator refers to 2004 with an update on AfDB, IMF and World Bank data at April 2007 and the denominator refers to a 2004-6 average; Sudan: 2006 Article IV Consultation and Staff-Monitored Program (IMF) – the numerator refers to 2005 and the denominator to 2003-5; and Togo: 2007 Article IV Consultation Concluding Statement of the IMF mission (IMF).
- c/. WEO. Liberia: HIPC Preliminary Document (2007). For the definition of total arrears see footnote 1 and 3 of Table 3.
- d/. WEO for total stock of arrears, WDI for population (2006), Liberia: HIPC Preliminary Document, World Bank staff estimates for Somalia. For the definition of total arrears see footnote 1 and 3 of Table 3.
- e/. Arrears are as of May 15, 2007.

47. The differences in economic circumstances suggest that there could be considerable variation in countries' own contributions to their respective arrears clearance operations. At the same time it is important to remember that the countries in arrears are in crisis, and could require considerable resource transfers in order to finance recovery programs, as well as in some cases to be able to service debts falling due between arrears clearance and the onset of HIPC interim period relief which begins at the HIPC decision point. Thus a determination of country contributions must be balanced against what is defensible from the point of view of ensuring that each country's recovery process has adequate financing. Furthermore, it should also be noted that high country contributions towards arrears clearance would have the effect of reducing the country's debt stock before the common

reduction factor⁴⁵ for HIPC debt relief has been calculated, which would in turn reduce the amount of HIPC debt relief that these countries would receive.

48. Some countries may also be able to attract donor resources to help finance arrears clearance. While the use of domestic and/or donor resources remains the preference of the Bank in terms of how arrears are cleared, it is nonetheless apparent that in most instances the amount of donor resources that could be made available is likely to be limited. In the past, only Afghanistan, which had arrears of a very limited size, has been able to have its arrears completely financed by donors.

49. The last source that should be considered is a country's IDA allocation. The countries currently on the list are all likely to receive exceptional IDA allocations, either under the exception for post-conflict countries, or under the re-engagement exception. In the past, countries re-engaging with IDA have used their IDA allocations as a source of financing for arrears clearance (e.g., DRC, 2002; CAR, 2006). In these past cases, however, allocations have been sufficient to cover the entire amount of the arrears as well to support the recovery program, which is not the case for most of the countries that remain in arrears.

Table 6. Total arrears compared to potential IDA allocation

	Total arrears to IBRD and IDA (US\$ million)	Potential IDA allocation (US\$ million) 1/	Ratio of arrears to allocation
Côte d'Ivoire	448.8	182	2.5
Liberia	473.1	35	13.5
Myanmar	233	252.5	0.9
Somalia	161.6	82	2.0
Sudan	429.8	362	1.2
Togo	113	30.5	3.7
Zimbabwe	496.2	65	7.6
	2355.5		

Note: 1/. Assumes that Côte d'Ivoire, Liberia, Somalia and Sudan will be eligible for exceptional post-conflict allocations, and that Myanmar, Togo and Zimbabwe will be eligible for exceptional re-engagement allocation, in line with the levels proposed for the IDA15 period. Based on 2005 population data.

50. Liberia is the most obvious example of a country where IBRD and IDA arrears outstrip its allocation. It is also a country devastated by protracted and violent conflict, and with very substantial financing needs and zero payment capacity. In this case IDA would not be able to meet its development mandate unless the financing of arrears clearance was considered separately from the financing of the recovery program. For other countries it is possible that a share of the IDA allocation could be applied towards the financing of arrears without jeopardizing recovery efforts. IDA would need to assess this on a case-by-case basis at the time when each arrears clearance package is being assembled.

⁴⁵ The "common reduction factor" is the fraction of debt that creditors' are asked to forgive in order to bring the country's debt ratio back to a sustainable level (150 percent of exports or in certain cases 250 percent of fiscal revenues).

51. **Requirements of other creditors:** The determination of the country contribution is also impacted by the requirements of other creditors. If, for example, one preferred creditor requires that the country repays a certain percentage of the arrears as a condition for arrears clearance, then the Bank will need to be repaid at the same level relative to the arrears. That is, the Bank requires *pari passu* treatment with other preferred creditors.

52. In this connection it should be noted that AfDB has in place an arrears clearance framework (the Post-Conflict Country Facility – PCCF) that uses a one-third share as the guideline for how much each country should contribute towards the cost of arrears clearance. This framework has been implemented flexibly in previous cases, with the one-third guideline being reduced to take account of limited country capacity to pay. Given the Bank’s preferred creditor status, the Bank would not be able to accept an arrears clearance arrangement that would give it a lower share than what AfDB would receive under the PCCF.

53. **Payment capacity and resource needs assessment:** To determine the precise level of exceptional IDA resources that IDA would need to allocate in each arrears clearance case, Bank staff would initiate an assessment of payment capacity and resource needs once a country in arrears starts the process of re-engagement with the Bank and other creditors. The Bank would undertake such assessments in conjunction with other preferred creditors in arrears, relying in particular on the work that the Fund does to establish a fiscal framework in the context of its Staff Monitored Programs (SMPs) or Emergency Post-Conflict Assistance Programs (EPCAs).

54. The assessment would encompass three pillars under the broad context of a macroeconomic framework. The first pillar is to examine the availability of domestic resources. Components to consider in this context can be: (i) the level of international reserves relative to imports; (ii) a limit to use international reserves to repay the government’s external arrears; (iii) a balanced budget requirement; (iv) the level of domestic capital market development to absorb a new issuance of government bonds; and (v) the level of the government’s net deposits in the banking system and in the central bank – consistent with the IMF conditionality if any.

55. The second pillar is to assess the country’s debt sustainability, which would help IDA as well as other creditors to determine future financing terms for the borrower after arrears have been cleared. Staff would conduct a forward-looking debt sustainability analysis under the joint Bank-Fund debt sustainability framework (DSF) for low-income countries.⁴⁶ In addition to standardized analyses under the DSF, staff could examine how external debt dynamics vary depending on the size of the borrower’s own resource contribution towards arrears clearance.

56. The third pillar would be to assess the level of the financing gap. The financing gap indicates the need for new financing in the post-crisis/conflict period, including by examining the impact of the crisis/conflict, the availability of resources from other sources, the strength of the government’s reform program, etc. Financing gaps can be detected by

⁴⁶ See “Staff Guidance Note on the Application of the Joint Bank-Fund Debt Sustainability Framework for Low-Income Countries.” Prepared by the staff of IDA and the IMF, May 3, 2007.

the trade and services balance, current transfers, foreign direct investment and changes in foreign assets including changes in international reserves. Current transfers include any grant contribution the government has secured from donors for arrears clearance operations. Such an analysis would take into consideration whether a country would be eligible for support under the post-conflict or re-engagement provision, with the assumption that countries eligible for exceptional post-conflict support would have greater resource needs. Furthermore, this pillar would be particularly important for determining the share of the cost of arrears clearance that would be covered from a country's IDA allocation.

57. The share to be covered through an exceptional IDA allocation for arrears clearance would be the residual left after country/donor payments, and the share covered from the IDA allocation, have been deducted from total IBRD and IDA arrears (see Table 7). An important proviso here is that IDA's share would not be higher than for other multilateral creditors.

Table 7. Steps to calculate exceptional IDA allocation for arrears clearance

Total arrears to IBRD and IDA	–	Payments from country to reduce arrears (based on payment capacity assessment)	–	Share of arrears to be covered from IDA allocation	=	Exceptional IDA allocation in support of arrears clearance
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58. The payment capacity assessment and the calculation of the level of exceptional arrears clearance support from IDA would be the basis for an arrears clearance package which would be described in the Interim Strategy Note or other communication to the Executive Directors. The Board would need to approve each arrears clearance operation, and thus also each exceptional arrears clearance allocation as they are presented to the Board.

59. **Cost estimate of systematic approach for IDA15:** The uncertainty around the timing of arrears clearance, differences in country circumstances and about what other preferred creditors may require, mean that the costs for IDA15 cannot be precisely estimated. In view of the uncertainties, Management proposes to adapt the HIPC costing methodology to the costing of the systematic approach. For HIPC costs of IDA, Management projects the expected loss of credit reflows over the forthcoming replenishment period, which forms the basis for donors' compensatory HIPC contributions. For the following replenishment, the actual HIPC costs over the past three years are netted against original projections and the difference is reflected in donors' contribution amounts for HIPC costs over the following three-year period. Thus, Management has compiled a cost estimate based on the likely arrears clearance costs to be financed during the IDA15 period, as the basis for the amount requested from donors. If this amount is underutilized during IDA15, it will be carried forward into IDA16. If it is insufficient, then the shortfall will be added to the amount requested for IDA16. The costs incurred to finance arrears clearance in FY08 (the last year of IDA14) would be added to the IDA15 bill.

Table 8. Indicative cost estimate for IDA15 (in US\$ mil.) 1/

Country	Estimated time of arrears clearance	Estimated arrears at time of clearance	Country contribution towards clearance	Amount covered by IDA allocation	Residual to be financed under systematic approach	Estimated likelihood of arrears clearance before FY11	Final IDA15 cost estimate
Côte d'Ivoire 3/	FY08 Q3	550	150-300	50	200-350	100%	275
Liberia 2/	FY08 Q1	482	0	0	482	100%	482
Sudan 2/ 3/	FY10	553	100-215	100	238-353	50%	148
Togo 4/	FY09	150	20	25	105	100%	105
Zimbabwe 2/	FY11	805	0	10	795	50%	398
Total		2,540	270-535	185	1820-2085		1407

Notes:

1/ The figures are indicative and subject to change, including because of changes to countries' payment capacity and needs, as well as uncertainty regarding the levels of IDA15 allocations for post-conflict and re-engaging countries.

2/ See paragraph 61 below

3/ To calculate the final IDA15 cost for Côte d'Ivoire and Sudan, the mid-point of the range indicated for the residual to be financed under the systematic approach was used.

4/ Bank staff estimates.

60. The estimate provided in Table 8 suggests that the cost of arrears clearance that is likely to be incurred during the last year of IDA14, and during the IDA15 period, amounts to about US\$1.4 billion. This number reflects estimated 100 percent likelihood of arrears clearance for Côte d'Ivoire, Liberia and Togo, and 50 percent likelihoods for Sudan and Zimbabwe. It is important to note that this is a highly indicative estimate; the actual distribution in each arrears clearance package between the country contribution, the IDA allocation and the set-aside for the systematic approach could vary considerably.

61. The estimate does not take account of two factors that could significantly reduce the total cost. First, the size of IBRD arrears for Liberia and Zimbabwe could be reduced subject to Board approval of a proposed retroactive change to IBRD's policy for calculating interest charges on overdue principal payments. The impact of this policy change is estimated at US\$109.4 million through March 31, 2007 for Liberia, and US\$13.3 million for Zimbabwe.⁴⁷ This policy change is expected to be discussed by the Board in June 2007. Second, current cost estimates could be reduced if countries experience significant delays in reaching the HIPC decision point. For instance, in the case of Sudan, given current projections on oil export volumes and prices, it would only be a matter of time before the country's debt-to-export ratio declines below the HIPC threshold (after taking into account traditional debt relief). Thus a significant delay in the decision point for Sudan could have significant downward implications for the cost of exceptional support for arrears clearance, since HIPC-eligibility is a requirement for such support. Management would adjust the cost estimates as new information becomes available; in

⁴⁷ See "Review of Interest Charges on Overdue Principal Payments of Fixed Rate Loans and Special Treatment for Countries with Fixed Rate Loans Presently in Non-Accrual," pp.2-3, SecM2007-0230, May 16, 2007, the World Bank.

particular the outcome of the Board discussion of the IBRD interest policy change could be included in the final cost estimates for IDA15.

62. In terms of the financial dynamics of support for arrears clearance, it is important to note that resources used upfront for arrears clearance lead to a commensurate reduction in the amount of resources needed from donors to deliver IDA's share of HIPC debt relief. This is because under the HIPC Initiative the concessional support for arrears clearance provided prior to the decision point can be counted towards each MDB's share of HIPC debt relief.⁴⁸ Thus any concessional support provided at arrears clearance reduces the amount of HIPC debt relief that the Bank would have to provide during the interim period or at the HIPC completion point. **Exceptional IDA support for arrears clearance simply frontloads the delivery of HIPC debt relief.** It should also be noted that any payments from domestic resources to reduce the size of the arrears in advance of arrears clearance would however reduce the cost to donors of the HIPC initiative. Similarly, any share of the arrears coming from each country's IDA allocation would also reduce the direct cost of HIPC debt relief to donors.

63. Table 9 shows how much of the debt relief that IDA needs to provide under the HIPC Initiative would be provided through the arrears clearance, and how much would remain to be provided as interim and post-completion point relief. The last column shows the remainder of IDA debt that would need to be cancelled under the MDRI. Using the mid-point of the ranges indicated below, the data show that IDA would provide a full 68 percent of its required HIPC debt relief through the concessional clearance of arrears, leaving 32 percent to be provided during the interim period and the HIPC completion point. The last column shows that up to an estimated US\$2.27 billion would be provided in nominal debt stock cancellation under the MDRI initiative, thus completing the debt relief process for these countries.

⁴⁸ In cases where multilateral creditors grant a concessional clearance of arrears prior to decision point, the NPV reduction embedded in the operation is scored as part of the creditor's share of HIPC Initiative debt relief. In such circumstances, the NPV of debt for the purpose of determining the amount of HIPC assistance is based on the estimated debt outstanding at the reference date under the assumption that no arrears clearance operations had taken place. The objective of taking this approach is to remove potential disincentives for the early settlement of arrears on concessional terms so that HIPCs with arrears can progress toward decision point rapidly. It is also intended to discourage "free riding" by ensuring that the clearance of one creditor's arrears does not lead to a reduction in the common reduction factor, thereby reducing the amount to be provided by all other creditors. See the "Joint Bank/Fund Note on the Heavily Indebted Poor Countries (HIPC) Debt Initiative – Approach to Arrears to Multilateral Institutions" in Attachment 1 of the "HIPC Debt Initiative: the Chairman's Summary of the Multilateral Development Banks' Meeting," March 6, 1998 (IDA/Sec M98-90).

**Table 9. Delivery of remaining debt relief from IDA
(US\$ million in NPV terms unless otherwise indicated) 1/**

Country	Total debt relief to be provided under HIPC	Debt relief delivered at arrears clearance	Remaining debt relief to be delivered under HIPC	Nominal debt stock cancellation under MDRI 2/
Côte d'Ivoire	506	250-400	106-256	1,289-1,487
Liberia	469	469	0	63
Sudan 3/	768	338-453	314-429	86-270
Togo	190	130	59	449
Zimbabwe	n.a.	n.a.	n.a.	n.a.
Total	1,931	1,187-1,452	480-745	1,887-2,269

Notes:

1/ The estimates are indicative only, and could change considerably if there are changes to the dates assumed for arrears clearance (Table 8) and for attaining the HIPC decision and completions points (Table 4).

2/ Corresponds to the nominal stock cancellation under MDRI and excludes post-completion point principal payments that would have been covered by HIPC debt relief.

3/ A delay in reaching a HIPC decision point could mean that Sudan would be no longer eligible for the HIPC initiative. Current projections on oil prices and volumes offer a likely scenario that, post-traditional debt relief, the country's NPV of debt-to-exports ratio could decline below the HIPC threshold (150 percent).

64. While exceptional support for arrears clearance significantly frontloads IDA's share of HIPC debt relief, eligible countries would still need to complete HIPC requirements in order to access HIPC interim and post-completion point relief, as well as the MDRI debt stock cancellation. With the exception of Liberia, which would have 100 percent of its HIPC relief delivered at arrears clearance, the other countries would receive substantial shares of their HIPC and MDRI debt relief only at the completion of HIPC process requirements. Furthermore, other creditors would also need to deliver their debt relief, which means that in aggregate there will still be a strong incentive on the part of the eligible countries to meet HIPC track record requirements, even with the frontloading that arrears clearance support entails. Furthermore, IDA's performance-based allocation system also adds a strong incentive to perform.

65. **Post-HIPC decision point debt and allocation dynamics:** Since the bulk of HIPC debt relief is shifted to the arrears clearance point, some countries, and particularly those with low HIPC common reduction factors, could receive limited debt service relief in the HIPC interim period. This may pose a problem in terms of IDA's ability to provide net positive transfers during the two to three years that it could take for countries to reach the HIPC completion point. The problem is likely to be most noticeable in Côte d'Ivoire and Zimbabwe (assuming the latter becomes eligible for HIPC assistance) since both countries will have substantial debt service in the years following arrears clearance. It may also be a problem for Togo, which like Zimbabwe would likely receive the relatively lower re-engagement allocations from IDA. Furthermore, even if each annual allocation exceeds debt service due by a comfortable margin, in terms of net flows, countries could still be negative if the pace of disbursements on new operations is slow. Lastly, if these countries' performance declines, that will reduce the level of their exceptional allocations from IDA, which could lead to added pressure on their ability to remain current on debt service falling

due. Management will monitor this issue and is also exploring options for how to provide additional assistance to countries that risk a relapse into arrears during the interim period. Such options could include e.g., shortening the interim period, additional support for debt service or increased ability to frontload IDA allocations.

VI. Financing of the Systematic Approach

66. As discussed above, the additional cost of the systematic approach is limited in the context of existing donor commitments to finance debt relief, and on the assumption that Myanmar and Zimbabwe would become HIPC eligible. As indicated above, Management proposes to include the estimated cost of arrears clearance for the countries expected to clear arrears before the end of the IDA15 period as a financing item in the IDA15 financing framework. Any unused resources during IDA15 would be carried over into IDA16, and used to finance arrears clearance when the eligible countries become ready to re-engage. If the resources requested for IDA15 are insufficient, the shortfall would be made up for in IDA16, in a way similar to how HIPC costs are updated from replenishment period to replenishment period based on usage.

67. Management is also proposing to widen the scope of the HIPC Trust Fund to allow it to receive donor contributions for arrears clearance, as well as possible contributions from IBRD net income, which would be used to address any remaining structural gap in the MDRI financing framework of IDA. Attachment 1 sets forth the related proposed changes to the HIPC Trust Fund Resolution. Any donor making bilateral contributions towards coverage of arrears clearance costs into the new window of the HIPC Trust Fund, ahead of IDA15, will have the option of having these contributions credited against the donor's burden-shared contributions for arrears clearance financing during IDA15.

68. The Executive Directors of the IBRD and IDA may amend the HIPC Trust Fund Resolution, subject to prior agreement by affected HIPC donors. Specifically, donors whose contributions to the Trust Fund represent at least a majority of all contributions of such affected donors must have agreed to such amendment. Attachment 2 provides a form of such agreement, to be provided by affected donors prior to consideration by the Executive Directors.

69. Lastly, in cases of countries with debt to IBRD, authorization would be required in IDA15 for IDA to provide IDA debt relief grants or credits which could be needed in order for the Bank to deliver its share of debt relief under the HIPC Initiative. Debt relief grants from IDA (for interim HIPC relief on IBRD debt service payments) and prepayment by IDA of remaining IBRD claims at the HIPC completion point are an agreed part of the HIPC process, and were explicitly authorized in the IDA13 replenishment. The only countries for which such assistance could be required are Côte d'Ivoire and Zimbabwe, if Zimbabwe is reclassified as a HIPC. The amounts required for this purpose are not expected to be significant.

VII. Issues for Discussion

70. Management seeks the views of Deputies on:

- The proposed eligibility criteria and re-engagement principles, and the use of exceptional IDA allocations for arrears clearance for eligible countries.
- The proposed increased flexibility for how IDA pre-arrears clearance grants are used, as proposed in paragraph 41.
- The appropriateness of the principles for determining the cost of the systematic approach, and of the proposed mechanism for financing costs to donors through the replenishment.
- The widening of the scope of the HIPC trust fund to receive donor contributions for Liberia's arrears clearance before IDA15 negotiations are concluded, as well as potential IBRD net income transfers to finance the MDRI structural gap.

ATTACHMENT 1

DRAFT AMENDMENTS
June 6, 2007

Resolution No. 96-9
Resolution No. IDA 96-5

Establishment of ~~HIPC-Debt Initiative~~Relief Trust Fund

WHEREAS:

(A) the Executive Directors of the International Bank for Reconstruction and Development ("IBRD") and the International Development Association (the "Association") and the Executive Board of the International Monetary Fund (the "IMF") ~~have~~ endorsed a program of action for reducing the debt burden of eligible, heavily indebted poor countries ("HIPCs") to a sustainable level under the framework of a HIPC Debt Initiative (the "Initiative");

(B) the Initiative ~~envisages~~envisaged the establishment of a trust fund (the "Trust Fund") to be administered by the Association as a mechanism to facilitate the fulfillment of commitments made by certain multilateral creditors to provide relief on debts owed to them by eligible HIPCs in accordance with the HIPC Initiative Board documents to be approved by the Executive Directors under the Initiative for each such eligible HIPC;

(C) the Board of Governors of IBRD ~~have~~ authorized the transfer by IBRD of US\$500 million as an initial contribution to the Trust Fund when other creditors of the countries eligible for the Initiative ~~are~~were determined by IBRD to have agreed to meet their share of the costs envisaged under the Initiative and the Board of Governors subsequently authorized the transfer by IBRD of additional contributions to the Trust Fund;

(D) it is expected that other donors will also contribute resources by way of grant to the Trust Fund; ~~and~~

(E) the Association has agreed under the Multilateral Debt Relief Initiative ("MDRI") to cancel the remaining debts owed to it by HIPCs once a HIPC reaches the completion point under the Initiative and it is desirable to expand the scope of the Trust Fund to allow contributions to assist in financing the costs to the Association of debt cancellation under the MDRI;

(F) some countries eligible to participate in the Initiative have accumulated arrears to IBRD and the Association which must be cleared before such countries can reach the decision point under the Initiative and it is desirable also to expand the scope of the

Trust Fund to allow contributions to assist in funding the costs to the Association of the clearance of such arrears; and

(G) the Association is prepared to establish and administer the Trust Fund on the terms and conditions set forth below;

NOW THEREFORE it is hereby resolved that:

1. Definitions. Unless the context otherwise requires, the several terms defined in the Preamble to this Resolution shall have the respective meanings therein set forth and the following additional terms shall have the following meanings:

- a) "Administrator" means the Association acting in the capacity as administrator of the Trust Fund;
- b) "Preliminary DSA" means a debt sustainability analysis prepared by the Association in consultation with the IMF and the debtor country concerned in order to determine a HIPC's eligibility for the Initiative;
- c) "Eligible Arrears Clearance Country" means a country determined by the Administrator to be in arrears to the Association as of December 31, 2006;
- d) "Eligible Creditor" means, in the case of funding from the Trust Fund in respect of the Initiative, IBRD, the Association and any other multilateral creditor that is either a donor to the Trust Fund or in respect of which another donor or donors have made contributions to the Trust Fund in a minimum aggregate amount equivalent to at least one million United States dollars and, in the case of funding from the Trust Fund in respect of MDRI or arrears clearance, the Association; and
- e) "Eligible HIPC" means a country determined by the Executive Directors of the Association to qualify for benefits under the Initiative.

2. Establishment. The Trust Fund is hereby established as a trust fund of the Association, constituted of the funds that shall from time to time be contributed in accordance with the provisions of this Resolution, and any other assets and receipts of the Trust Fund.

3. Authorization and Administration. The administration of the Trust Fund shall be governed by the following provisions:

- a) The Administrator is authorized to accept contributions to the Trust Fund ~~from IBRD and other donors~~ at any time after the effectiveness of the Trust Fund for the purpose of providing financing to Eligible Creditors (i) from IBRD and other donors in order to relieve the debt service burden of Eligible HIPCs to Eligible Creditors under the framework of the Initiative; (ii) from IBRD in

order to finance the cost to Eligible Creditors of debt cancellation under MDRI; and (iii) from donors other than IBRD in order to fund the cost to Eligible Creditors of the clearance of arrears of Eligible Arrears Clearance Countries. Except in the case of contributions from IBRD, the Administrator shall enter into an agreement with each donor, in form and substance satisfactory to the Administrator, whereby the donor will agree to make its contribution to the Trust Fund. At the election of the donor, the donor may enter into one agreement with the Administrator covering its entire contribution to the Trust Fund or may enter into separate agreements with the Administrator for contributions to be made to the Trust Fund at separate times ~~over~~during the course~~term~~ of the ~~initiative~~Trust Fund. At the election of the donor, contributions may be made either as (i) unrestricted contributions ("HIPC Core Contributions") to be used to make payments to any Eligible Creditor for the Initiative; (ii) ~~restricted~~unrestricted contributions ("Arrears Clearance Core Contributions") to be used to make payments to ~~a specifically identified~~any Eligible Creditor ("Creditor Specific Contributions"); ~~or for arrears clearance~~; (iii) restricted contributions to be used to make payments to a specifically identified Eligible Creditor for either the Initiative, MDRI (if the donor is IBRD) or arrears clearance, as so designated by the donor ("Creditor-Specific Contributions"); or (iv) restricted contributions to be used to make payments with respect to debts owed by a specifically identified Eligible HIPC or Eligible Arrears Clearance Country for either the Initiative, MDRI (if the donor is IBRD) or arrears clearance as so designated by the donor, provided that in the case of contributions for MDRI or arrears clearance, such contribution also specifies the Eligible Creditor with respect to which such contribution is to be used ("Country-Specific Contributions"). A donor may elect to make all of its contributions as HIPC Core Contributions, Arrears Clearance Core Contributions, Creditor-Specific Contributions or Country-Specific Contributions or may elect to split its contributions among HIPC Core Contributions, Arrears Clearance Core Contributions, one or more Creditor-Specific Contributions and one or more Country-Specific Contributions, in such amounts as designated by the donor to the Administrator. If the donor does not make an election, its contribution shall be deemed to be made as a ~~Core Contribution~~HIPC Core Contribution. In addition, any unrestricted contributions made by a donor prior to [date of effectiveness of the amendment to the Resolutions to be included], 2007 shall be deemed to be made as a HIPC Core Contribution. If a donor makes a Country-Specific Contribution, the donor may designate whether such Country-Specific Contribution may be used to make payments in respect of debt owed to one or more specific Eligible Creditors or all Eligible Creditors. Notwithstanding the foregoing, unless a donor otherwise instructs the Administrator, any contributions received by the Trust Fund prior to [date of effectiveness of the amendment to the Resolutions to be included], 2007 shall be used only to provide financing with respect to the Initiative.

- b) The Administrator shall ~~hold~~manage and use the funds so contributed to the Trust Fund and all other assets and receipts of the Trust Fund ~~in trust for the benefit of Eligible HIPCs. The Administrator shall manage and use such funds, assets and receipts~~ only for the purposes of, and in accordance with, the

provisions of this Resolution, keeping them separate and apart from the assets of IBRD and the Association but may commingle them for investment purposes with other trust fund assets maintained by the Association or IBRD. The Administrator shall exercise the same care in the discharge of its functions under this Resolution as it exercises with respect to its own affairs and shall not have any additional liability with respect to the administration of the Trust Fund. The privileges and immunities accorded to the Association shall apply to the property, assets, archives, income, operations and transactions of the Trust Fund.

- c) The Administrator is authorized to perform all acts and enter into all contracts as shall be necessary or desirable for the accomplishment of the purposes of the Trust Fund including, without limitation, agreements with donors concerning their contributions to the Trust Fund.
- d) Pending disbursement, the Administrator is authorized to invest funds held by the Trust Fund in such manner as the Administrator may decide, consistent with the criteria for investment of the Administrator's own funds. All the income from such investment shall be credited to, and used exclusively for the purposes of, the Trust Fund, except that if a donor so requires, the income from the investment of the funds provided by that donor shall be paid to the donor. Such income shall be credited to the various components of the Trust Fund on a pro rata basis. The Association shall not be entitled to any compensation for acting as Administrator.
- e) The Administrator shall, as soon as practicable after the end of each fiscal year of the Association, furnish to each donor to the Trust Fund: (i) a report on the operation of the Trust Fund; and (ii) a financial statement for the Trust Fund, together with an opinion of the Association's external auditors on such statement.

4. Payment of Contributions. Payment of contributions to the Trust Fund shall be made in the following manner:

- a) Payment of contributions from IBRD shall be made in cash at such time and in such amounts as may be specified by IBRD; provided that, IBRD's initial contribution of US\$500-million shall be made in full in cash when IBRD determines that those creditors holding a substantial portion of the debts of countries projected by IBRD to be eligible for the Initiative have agreed to meet their share of the costs envisaged under the Initiative, as evidenced by the agreement of such creditors in principle to participate in the Initiative on such basis.
- b) Payment of contributions by other donors shall be made in accordance with the provisions of the relevant agreements between the donors and the Administrator. Subject to the terms of such agreements, payments by such donors shall be made (i) in the case of members of the Association, in cash, on terms agreed by the donor and the Administrator, or by the deposit of notes or similar obligations denominated in any freely convertible currency and issued

by the government of the member or the depository designated by such member, which shall be non-negotiable, non-interest bearing and payable either in periodic installments at such times and in such amounts as agreed by the donor and the Administrator or at their par value on demand to the order of the Association as Administrator of the Trust Fund; or (ii) in the case of donors that are not members of the Association, in cash, on terms agreed by the donor and the Administrator, or by the deposit of notes or similar obligations denominated in any freely convertible currency and issued by the donor, which shall be non-negotiable, non-interest bearing and payable either in periodic installments at such times and in such amounts as agreed by the donor and the Administrator or at their par value on demand to the order of the Association as Administrator of the Trust Fund.

- c) Subject to the terms of the agreement between the donor and the Administrator and in accordance with the priorities on the use of Trust Fund resources set forth in ~~clause e) of paragraph 7~~ paragraphs 7, 9 or 10 of this Resolution, as the case may be, the Administrator shall be entitled to encash such notes or other obligations that are payable on demand as needed to meet the disbursement requirements of the Administrator under the Trust Fund. In so doing, the Administrator shall in providing financing for the Initiative or arrears clearance, to the extent practicable, endeavor to ensure an approximately pro rata disbursement of the funds contributed to the Trust Fund by all donors as HIPC Core Contributions and Arrears Clearance Core Contributions, as the case may be.
- d) At its discretion, the Administrator may at any time exchange any funds received by a donor for one or more other currencies in order to facilitate the administration of the Trust Fund.

5. Effectiveness. The Trust Fund shall become effective and may begin to accept contributions from donors upon approval of this Resolution by the Executive Directors of IBRD and the Association.

6. Operational ~~principles~~ Principles. The resources of the Trust Fund shall be used by the Administrator in accordance with the following principles:

- a) Trust Fund resources shall be used only to finance, on a grant basis, (i) debt relief on debts owed, by Eligible HIPC by Eligible HIPCs to Eligible Creditors; (ii) debt cancellation by Eligible Creditors under MDRI; and (iii) clearance of arrears of Eligible Arrears Clearance Countries to Eligible Creditors.
- b) Trust Fund resources may be made available to Eligible Creditors as grants to prepay the debt which an Eligible Creditor has agreed to include under the Initiative or to pay debt service on such debt as it falls due. Alternatively, the Administrator may use Trust Fund resources to purchase such debt from an Eligible Creditor, in which case the Administrator shall then immediately cancel such debt, or to make such other financial commitments as the Administrator shall deem appropriate with an Eligible Creditor which has the effect of reducing the present value of the debt service owed on such debt. Trust

Fund resources may also be made available to Eligible Creditors as grants to compensate them for debt cancellation under MDRI and to fund, or compensate them for the cost of, the clearance of arrears of Eligible Arrears Clearance Countries.

- c) Trust Fund resources shall not be used to finance any fees, penalties or other charges that may be due to an Eligible Creditor by an Eligible HIPC or an Eligible Arrears Clearance Country in respect of the prepayment of debt.

7. Operational Procedures for Funding for the Initiative. The resources of the Trust Fund shall be used by the Administrator for the Initiative in accordance with the following procedures:

- a) After the Association has prepared a Preliminary DSA in order to determine a HIPC's eligibility for the Initiative, the Administrator shall consult with the Association, the IMF, the HIPC country concerned and its creditors to ascertain the amount of debt relief projected to be needed from Eligible Creditors for such HIPC under the Initiative.
- b) Following such consultations and prior to the preparation of the HIPC Initiative Board document to be prepared by the Association under the Initiative, the Administrator shall make a preliminary determination of the maximum amount of resources that could be made available from the Trust Fund to assist Eligible Creditors to provide debt relief in respect of debts owed to them by such HIPC: In making such preliminary determination, the Administrator shall:
 - i) determine the amount of the Country-Specific Contribution that would be available to each Eligible Creditor in respect of debts owed to it by such HIPC;
 - ii) determine the amount of HIPC Core Contributions that would be available to each Eligible Creditor in respect of debts owed to it by such HIPC, in consultation with those donors that have made HIPC Core Contributions to the Trust Fund;
 - iii) determine the amount of the Creditor-Specific Contribution to the Trust Fund in respect of debts owed to each Eligible Creditor that would be potentially available to be used for such purpose; and
 - iv) consult with donors to the Trust Fund and with potential donors to the Trust Fund, to the extent the Administrator deems appropriate, to determine whether such parties are prepared to make additional contributions to the Trust Fund in respect of debts owed by such HIPC to Eligible Creditors.
- c) Following such determination, the Administrator shall inform each Eligible Creditor of the maximum amount that would potentially be available from the Trust Fund in respect of debts owed by such HIPC to such Eligible Creditor, indicating the currencies in which such amounts are expected to be available

from the Trust Fund. The Administrator shall also inform the Association and the IMF of the maximum amounts that would be potentially available from the Trust Fund in respect of debts owed by such HIPC to all Eligible Creditors so that they may take this information into account in preparing the HIPC Initiative Board document under the Initiative.

- d) If and when such HIPC has been determined by the Association to be an Eligible HIPC, an Eligible Creditor may submit a request to the Administrator for financing from the Trust Fund for the debt relief agreed by such Eligible Creditor to be provided under the Initiative on debts owed to it, indicating the amount of financing requested and the preferred manner of financing; provided that, unless the Administrator so agrees, the amount of financing so requested may not exceed the maximum amount previously indicated to such Eligible Creditor by the Administrator as potentially available from the Trust Fund for this purpose.
- e) The amount and method of financing to be provided from the Trust Fund for debt relief on debts owed by an Eligible HIPC to such Eligible Creditor shall be determined by the ~~President of the Association~~Administrator in keeping with the framework of the Initiative, in accordance with the following procedures and priorities:
 - i) First, to the extent that donors have made Country-Specific Contributions to the Trust Fund for such Eligible HIPC for the Initiative, the Administrator shall make available to such Eligible Creditor such amount of the Country-Specific Contribution for that Eligible HIPC as the donors have so specified in their respective agreements with the Administrator;
 - ii) Second, to the extent that donors have made HIPC Core Contributions to the Trust Fund, the Administrator shall make available to such Eligible Creditor such amount of the HIPC Core Contributions as shall have been approved by donors whose HIPC Core Contributions represent at least a majority of all HIPC Core Contributions, after taking into account funding anticipated to be provided to such Eligible Creditor from the Creditor Specific Contributions that donors have made to the Trust Fund for such Eligible Creditor for the Initiative.
 - iii) The method by which such financing will be provided by the Trust Fund shall be determined by the ~~President of the Association~~Administrator in consultation with the Eligible Creditor:
- f) Unless otherwise agreed by the Administrator, the financing to be provided from the Trust Fund for debt relief on debt owed by an Eligible HIPC to such Eligible Creditor shall commence at the completion point as determined under the Initiative for such Eligible HIPC.

- g) The financing to be provided to an Eligible Creditor from the Trust Fund in respect of debt relief for debts owed by an Eligible HIPC to such Eligible Creditor shall be evidenced by an agreement between the Administrator and such Eligible Creditor on terms and conditions satisfactory to the ~~President of the Association~~ Administrator, which such agreement shall indicate in particular that the resources are being provided from the Trust Fund. The Administrator may enter into such an agreement with an Eligible Creditor concurrently with, or at any time subsequent to, the decision point as determined under the Initiative and such Eligible Creditor's determination to participate in the Initiative with respect to such Eligible HIPC. The Administrator shall carry out its obligations under such agreement, subject to the availability of funds in the Trust Fund to make the payments provided for in such agreement and the fulfillment of the conditions precedent initially agreed upon for the provision of such debt relief by the Eligible Creditor.
- h) If at the completion point as determined under the Initiative, the updated DSA prepared at that time indicates that the debt relief agreed by an Eligible Creditor at the decision point under the Initiative would not result in the achievement of the target debt range established at the decision point under the Initiative and such Eligible Creditor proposes to provide additional debt relief, the Administrator will determine whether it is possible to provide additional Trust Fund resources to assist in financing such additional debt relief. The Administrator will follow the procedures set forth in this paragraph 7, mutatis mutandis, in making such determination and in providing any such- additional resources to such Eligible Creditor.
- i) If at the completion point as determined under the Initiative, the updated DSA prepared at that time indicates that an Eligible Creditor does not need to provide as much debt relief as such Eligible Creditor agreed at the decision point and as a result the debt relief to be provided by such Eligible Creditor is reduced, the amount of financing to be provided from the Trust Fund shall be reduced accordingly and the excess funds shall be available to finance debt relief on debts owed by other Eligible HIPCs.

8. Interim Measures. If a donor so specifies, and if the relevant Eligible Creditor so requests in keeping with the framework of the Initiative, the Administrator shall make available the amount of contribution so specified in advance of the completion point as determined under the Initiative to finance debt relief agreed by such Eligible Creditor to be provided under the Initiative prior to such completion point.

9. Operational Procedures for Funding for MDRI. The resources of the Trust Fund shall be used by the Administrator for MDRI in accordance with the following procedures:

- a) Once an Eligible HIPC has reached the completion point under the Initiative, the Administrator may provide financing to an Eligible Creditor to assist in funding the cost of debt cancellation provided by such Eligible Creditor to such Eligible HIPC under MDRI.

- b) The amount of such financing to be provided from the Trust Fund shall be determined by the Administrator in accordance with the following priorities:
- i) First, to the extent that IBRD has made Country-Specific Contributions to the Trust Fund for such Eligible HIPC for MDRI, the Administrator shall make available to such Eligible Creditor such amount of the Country-Specific Contribution for that Eligible HIPC as IBRD has so specified;
 - ii) Second, the Administrator shall make available to such Eligible Creditor such amount of the Creditor Specific Contributions that IBRD has made to the Trust Fund for such Eligible Creditor for MDRI.
- c) The financing to be provided to an Eligible Creditor from the Trust Fund in respect of debt cancellation under MDRI for debts owed by an Eligible HIPC to such Eligible Creditor shall be evidenced by an agreement between the Administrator and such Eligible Creditor on terms and conditions satisfactory to the Administrator, which such agreement shall indicate in particular that the resources are being provided from the Trust Fund. The Administrator shall carry out its obligations under such agreement, subject to the availability of funds in the Trust Fund to make the payments provided for in such agreement and the fulfillment of the conditions precedent initially agreed upon for the provision of such debt relief by the Eligible Creditor.

10. Operational Procedures for funding for Arrears Clearance. The resources of the Trust Fund shall be used by the Administrator for arrears clearance in accordance with the following procedures:

- a) Once an Eligible Arrears Clearance Country has been determined by the Administrator to qualify for the provision of resources under the Trust Fund for arrears clearance, the Administrator may provide financing to an Eligible Creditor to assist in funding the cost to such Eligible Creditor of arrears clearance for such Eligible Arrears Clearance Country.
- b) The amount of such financing to be provided from the Trust Fund shall be determined by the Administrator in accordance with the following priorities:
 - i) First, to the extent that donors have made Country-Specific Contributions to the Trust Fund for such Eligible Arrears Clearance Country, the Administrator shall make available to such Eligible Creditor such amount of the Country-Specific Contribution for that Eligible Arrears Clearance Country as the donors have so specified in their respective agreements with the Administrator;
 - ii) Second, to the extent that donors have made Arrears Clearance Core Contributions to the Trust Fund, the Administrator shall make available to such Eligible Creditor such amount of the Arrears

Clearance Core Contributions as are needed to clear arrears of an Eligible Arrears Clearance Country, after taking into account funding anticipated to be provided to such Eligible Creditor from the Creditor Specific Contributions that donors have made to the Trust Fund for such Eligible Creditor for arrears clearance.

- c) The financing to be provided to an Eligible Creditor from the Trust Fund in respect of arrears clearance for debts owed by an Eligible Arrears Clearance Country to such Eligible Creditor shall be evidenced by an agreement between the Administrator and such Eligible Creditor on terms and conditions satisfactory to the Administrator, which such agreement shall indicate in particular that the resources are being provided from the Trust Fund. The Administrator shall carry out its obligations under such agreement, subject to the availability of funds in the Trust Fund to make the payments provided for in such agreement and the fulfillment of the conditions precedent initially agreed upon for the provision of such debt relief by the Eligible Creditor.

11. Parallel Arrangements. The Administrator may enter into such arrangements as the Administrator deems appropriate, on such terms as shall be determined by the Administrator, with members of the Association and other entities in cases where such members or entities are prepared to make grants available directly to an Eligible Creditor or an Eligible HIPC or an Eligible Arrears Clearance Country to cofinance debt relief in parallel with the financing to be provided from the Trust Fund.

~~10.~~12. Unused Contributions. If the Administrator determines that any Country-Specific Contribution or Creditor-Specific Contribution to the Trust Fund will not be used, such unused contribution will be disposed of in the manner agreed by the Administrator and the relevant donor.

~~11.~~13. Amendment. The arrangements governing the Trust Fund set forth herein may be amended by resolution of the Executive Directors of IBRD and the Association, provided that, before any such proposed amendment is presented to the Executive Directors for consideration, if such proposed amendment affects the administration or use of a donor's contribution to the Trust Fund, those affected donors whose contributions to the Trust Fund represent at least a majority of all contributions of such affected donors must have agreed to such amendment.

~~12.~~14. Resignation and Removal of the Administrator. The Association may resign as Administrator at any time, or may be removed as Administrator upon the decision to do so by those donors whose contributions to the Trust Fund represent at least a majority of all contributions to the Trust Fund. Any such resignation or removal shall take effect upon the appointment of a successor administrator, approved by those donors whose contributions to the Trust fund represent at least a majority of all contributions to the Trust Fund.

~~13.~~15. Termination. The functions of the Association as Administrator of the Trust Fund shall terminate upon a decision to liquidate the Trust Fund by the Executive Directors of IBRD and the Association, based on their finding that the Trust Fund has fulfilled its purpose, or can no longer do so. Upon such decision by the Executive Directors, the

Administrator shall take all action necessary for winding up its activities as Administrator. Upon such termination, the Administrator shall distribute the assets of the Trust Fund to the donors in the proportion that the aggregate contributions of a donor bear to the aggregate contributions of all donors; provided that, any distribution to which IBRD is entitled shall be made to the Association as part of its general resources.

ATTACHMENT 2

The World Bank

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

1818 H Street N.W.
Washington, D.C. 20433
U.S.A.

(202) 477-1234
Cable Address: INTBAFRAD
Cable Address: INDEVAS

[Date]

[Name
Title
Government
Address]

Re: HIPC Debt Relief Trust Fund

Dear Sir/Madam:

I am writing on behalf of the International Development Association (the Association), as administrator (the Administrator) of the HIPC Debt Initiative Trust Fund (the HIPC Trust Fund), to request your consent to the amendment of Resolutions No. 96-9 and No. IDA 96-5 of the Executive Directors of the International Bank for Reconstruction and Development and the International Development Association (the Resolutions) for the establishment of the HIPC Trust Fund. Attached please find the proposed amended and restated Resolutions.

Please confirm your agreement with the proposed amendments by signing, dating, and returning to us the enclosed copy of this letter.

Very truly yours,
INTERNATIONAL DEVELOPMENT ASSOCIATION
As Administrator of the HIPC Debt Initiative Trust Fund

By _____

Philippe Le Houérou
Vice President
Concessional Finance and Global Partnerships

AGREED:
[Full donor name]

By _____
Name _____
Title _____

Date: _____

ANNEX

[Insert proposed revised resolution with track changes]