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World Bank Response to Financial Crises: The Special Development Policy Lending Option

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ABBREVIATIONS AND ACRONYMS

BP	Bank Procedure
CAS	Country Assistance Strategy
DPL	Development Policy Lending
EFF	Extended Fund Facility
ESAL	Emergency Structural Adjustment Loan
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IDB	Inter-American Development Bank
IFL	IBRD Flexible Loan
IMF	International Monetary Fund
LIBOR	London Interbank Offer Rate
OD	Operational Directive
OP	Operational Policy
SDPL	Special Development Policy Loan
SRF	Supplemental Reserve Facility
SSAL	Special Structural Adjustment Loan

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WORLD BANK RESPONSE TO FINANCIAL CRISES: THE SPECIAL DEVELOPMENT POLICY LENDING OPTION

I. INTRODUCTION

1. The global financial crisis and economic recession have brought about renewed attention to Special Development Policy Lending, the policy-based lending option the Bank uses on an exceptional basis for participation in international support packages for IBRD-eligible countries that are in or approaching a financial crisis.[1] For the Bank to join the IMF up-front in the response to a crisis, structural policy measures must be considered important to quickly restore market confidence, in addition to macroeconomic policy actions supported by the Fund. The Bank first introduced this instrument under the name emergency structural adjustment lending in October 1998[2]—drawing on experience with emergency lending to countries affected by the East Asian financial crisis including Indonesia, Korea, Malaysia, and Thailand—and subsequently changed its name and modified its features in the light of further experience with crisis lending.[3] Using this instrument, the Bank has participated in four international support packages—for Argentina in 1998, Brazil in 1999 and 2000, Turkey in 2001, and Uruguay in 2002.

2. ***Purpose of this Paper.*** Management has examined the use of Special Development Policy Lending as one of the Bank's instruments for responding to the current global financial crisis and economic recession.[4] In recent months, Executive Directors also have inquired whether the features of the Special Development Policy Lending Option—defining applicability, country eligibility, and financial terms—remain appropriate for the Bank's participation in IMF-led international rescue efforts for countries severely affected by the global financial crisis and economic recession. This paper reviews the evolution of the instrument and examines the need for updating the relevant provisions of OP 8.60, *Development Policy Lending*, the policy framework governing Special Development Policy Lending, and the financial terms set out in OP 3.10, *Financial Terms and Conditions of IBRD Loans, IBRD Hedging Products, and IDA Credits*.[5] Management proposes certain revisions to the policy framework and to the financial terms to enable the Bank to better respond to countries' financial crises in the context of the global financial crisis and economic recession.[6] Other Bank instruments for responding to the global crisis are not the subject of this paper.

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1 See OP 8.60, *Development Policy Lending*, paragraphs 24-26.

2 See *Programmatic and Emergency Adjustment Lending: World Bank Guidelines* (R98-249), September 4, 1998 (approved October 22, 1998).

3 See the Operational Memorandum *Guidelines for Special Structural Adjustment Loans,* April 19, 1999.

4 See *Financial Crisis Response and Use of Instruments* (Board Briefing), March 25, 2009.

5 See OP 3.10, *Financial Terms and Conditions of IBRD Loans, IBRD Hedging Products, and IDA Credits*, footnote 4.

6 OP 14.25, *Guarantees,* requires that a change in the pricing of Special Development Policy loans lead to an equivalent change in the fees for policy-based guarantees that are provided in association with special development lending support.

II. Evolution of Special Development Policy Lending

3. Bank policy on crisis lending evolved in steps as the Bank drew lessons from its response to financial crises in Mexico (1994), East Asian countries (1997), Russia (1998), Argentina (1998), Brazil (1999/2000), Turkey (2001), and Uruguay (2002), and as it moved from adjustment lending to development policy lending (2004).

4. ***East Asia.*** In the aftermath of the Mexico financial crisis, where the Bank had focused support on post-crisis structural reforms, the Bank reviewed its experience and concluded that its instruments provided sufficient flexibility for adequate crisis response, and a new instrument was not needed.[7] This informed the initial response to the East Asian financial crisis and to the subsequent crisis in Russia—operations approved in FY98 and early FY99 adapted existing instruments to clients' needs.[8] However, developments in East Asia and Russia revealed that countries' integration into global financial markets was changing the nature of financial crises: investor confidence was becoming an important factor for avoiding contagion, managing responses during crises, and recovering from crises. With markets considering not only macroeconomic fundamentals but also structural and social factors that underpin the country's performance—such as the strength of the banking system, of corporate governance, and of social safety nets—it had become important for the Bank to join the IMF in the initial support to countries in or approaching a financial crisis.[9] In September 1998 the Board discussed a paper that reviewed the Bank's experience with crisis support to East Asian countries and Russia, drew attention to the implications of further crisis support for the Bank's ability to maintain core lending programs given the Bank's limited risk-bearing capacity, and considered the introduction of a special instrument with special financial terms for the Bank's early engagement in concerted crisis support.[10] Executive Directors emphasized that the Bank should not provide liquidity support *per se*, but that early engagement would be consistent with the Bank's mandate to promote growth and poverty reduction and with its areas of expertise when the crisis had significant structural and social dimensions and the concerted package supported a strong program of macroeconomic, structural, and social policies.

5. ***Emergency Structural Adjustment Lending.*** In October 1998 the Board approved management's proposal for the introduction of the emergency structural

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7 See *Note on the Lessons for the World Bank of the Mexico Crisis,* Office of the Senior Vice President, Development Economics, and Chief Economist (SecM96-1053), October 15, 1996; and *Strengthening the Bank's Response to Economic Crises* (Sec M97-344), May 2, 1997.

8 See Thailand: *Financial Sector Implementation Assistance Project* (R97-24), March 13, 1997; Korea: *Economic Reconstruction Loan* (R97-289), December 19, 1997; Korea: *Structural Adjustment Loan* (R98-63), March 19, 1998; Indonesia: *Policy Reform Support Loan* (R98-209), April 29, 1998; Malaysia: *Economic Recovery and Social Sector Loan* (R98-147), June 2, 1998; and Russia: *Third Structural Adjustment Loan* (R98-98), July 27, 1998. Special loan charges were applied for lending to Korea, which had previously graduated but became again eligible for IBRD lending.

9 See *The Bank's Response to Financial Crises: Instrument Design* (R97-288), December 18, 1997.

10 See *Financial Crisis and Structural Reform: The Bank's Role and Instruments* (SecM98-743), September 4, 1998. The paper cited incremental commitments of $8.4 billion through the crisis support operations approved in FY98 and early FY99 and pointed out that their increased risk required exceptional additional risk capital to support them.

adjustment loan (ESAL) as the special instrument for Bank participation in concerted international support packages and guidelines for the instrument's use.[11] The ESAL would be available on an exceptional basis to creditworthy countries facing a crisis with substantial structural and social dimensions at financial terms that reflect both the special nature and the high risks of this support. The ESAL guidelines rooted the rationale for Bank participation in the structural causes of financial crises and their major social consequences, and also referred to crises as windows of opportunity that might otherwise have remained closed. They also emphasized that crises are intrinsically unanticipated and therefore, by definition, ESAL support falls outside the Bank's normal financial planning process. The guidelines placed the ESAL within the overall policy framework for adjustment lending,[12] and set out the following special features:

- ***Applicability.*** For ESAL support, a crisis had to have substantial structural and social dimensions, with Bank participation needed to help articulate the reform program and contribute to the restoration of market confidence, financial health, and growth. ESALs were to be used on an exceptional basis, and therefore each one required justification. The magnitude of any ESAL was subject to the availability of adequate IBRD financial and risk-bearing capacity.

- ***Eligibility.*** For a country to be eligible for ESAL support, (a) the structural and macroeconomic policy package had to be satisfactory, with conditionality embedded in a strong policy program; (b) the ESAL had to be part of a concerted international support package, which would normally include IMF financing and would provide for appropriate burden-sharing among multilaterals, bilateral donors, and private lenders and investors; (c) the country's external financing plan had to be likely to be sustainable, with the ESAL and its associated debt service within medium-term debt sustainability limits; and (d) the country had to be IBRD-eligible.

- ***Financial terms.*** The financial terms of ESALs reflected the special nature and high risks of lending for crisis support above anticipated levels. Specifically, the maturity and grace period were shorter (reflecting the need to replenish the Bank's financial pool for this type of lending) and pricing higher (reflecting the higher risk and costs to the Bank) than for other Bank instruments. The guidelines specified the financial terms, among them a maturity of 5 years, a grace period of 3 years, and a minimum loan spread of 400 basis points, which could vary over time for new loans, depending on the Bank's overall risk-bearing capacity and market conditions. Other IBRD loan charges (including the front-end fee and the commitment fee) and loan charge waivers also applied to ESALs. (The Bank formulated the ESAL pricing taking into account the pricing of the IMF's Supplemental Reserve Facility).

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[11] See *Programmatic and Emergency Adjustment Lending: World Bank Guidelines* (R98-249), September 4, 1998 (approved October 22, 1998).

[12] See OD 8.60, *Adjustment Lending Policy,* and *Issues in Adjustment Lending* (SecM96-18), January 16, 1996.

6. ***Argentina and Brazil.*** The ESAL guidelines governed the Bank's participation in international support packages for Argentina and Brazil, though the loans were renamed special structural adjustment loans (SSALs). The Board approved two loans to Argentina in November 1998 and a framework paper for support to Brazil in December 1998.[13] On both occasions, Executive Directors discussed appropriate burden-sharing with the IMF and also cautioned about references to burden-sharing with private investors and lenders. Management and the Board then agreed on clarifications—regarding burden-sharing and such other issues as early communications on crisis support operations with Executive Directors—that were subsequently included in SSAL guidelines issued to staff in April 1999.[14] Executive Directors later requested, on the occasion of discussing crisis support to Turkey in 2001, additional information on the composition of the international support packages for Argentina and Brazil.[15]

7. ***SSAL Guidelines.*** The SSAL guidelines, which were issued to staff in April 1999,[16] committed Management to early communications with Executive Directors on upcoming SSAL operations, reconfirmed the exceptional nature of the instrument's use, and also maintained the other features of ESALs, with the following modifications:

- ***Applicability.*** The SSAL guidelines clarified that a financial crisis qualifying for SSAL support could be an actual or potential (approaching) crisis, and that the country's financing needs must be exceptional. They maintained the requirement that the crisis must have substantial structural and social dimensions, but dropped as unnecessary the reminder that Bank participation is needed to articulate the reform program.

- ***Eligibility.*** The SSAL guidelines clarified that an IMF program must be in place. In a separate statement on partnership with the IMF, the guidelines stated that the objective of consultations with the IMF is to ensure appropriate burden-sharing and phasing of disbursements and that, as a general rule, Bank disbursements do not precede, but proceed in parallel with or follow, IMF

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[13] See Argentina: *Special Structural Adjustment Loan and Special Repurchase Facility Support Loan* (R98-267), November 3, 1998; and *Framework Paper: Special Program of Support for Brazil* (SecM98-943), November 25, 1998.

[14] See the Operational Memorandum *Guidelines for Special Structural Adjustment Loans,* April 19, 1999.

[15] See *Special Structural Adjustment Loans: Composition of International Support Packages* (SecM2001-0308), May 2001. This paper showed that the Bank contributed about $3 billion in two loans to the Argentina package, and that it planned to contribute $4.5 billion in four loans to the Brazil package, of which about $2.5 billion were committed. In addition, the Argentina package included a $2.8 billion IMF Extended Fund Facility (EFF) under regular terms and a $2.5 billion loan from the Inter-American Development Bank (IDB). However, Argentina made no purchases under the EFF, and there was no bilateral or private sector contribution. The Brazil package included an $18.1 billion IMF three-year Stand-By arrangement (including $12.7 billion Supplemental Reserve Facility financing), $4.5 billion in two loans from the IDB, and $14.5 billion in credit facilities backed by the central banks of industrialized countries. Again, as in the Argentina package, there was no contribution from private sources.

[16] See *Guidelines for Special Structural Adjustment Loans,* op. cit.

disbursements. The requirement of appropriate burden-sharing with other participants of an international support package was dropped.

- ***Financial terms.*** The SSAL guidelines did not modify the financial terms set out in the ESAL guidelines.

8. ***Turkey and Uruguay.*** Following the financial crisis of the late 1990s, Bank crisis support remained rare, underscoring the exceptional nature of SSAL support but also attesting to many countries' achievements in addressing the structural weaknesses that had made them vulnerable to contagion. The Bank participated in international rescue packages for Turkey in 2001 and Uruguay in 2002. In these cases the Bank provided support both on standard terms for structural reforms suitable for strengthening resilience to future crises, and on SSAL terms to help the government manage its responses to the financial crisis, specifically by supporting up-front actions in the financial sector.

- ***Turkey.*** In February 2001, Turkey experienced a major currency crisis, attributable to weaknesses in the financial sector, but with deeper roots in the structure and management of the public sector that caused chronic macroeconomic instability. To restore market confidence, an international rescue package needed to include the start of a credible medium-term program of reforms in those sectors designed to strengthen resilience against a future crisis, in addition to up-front actions in the banking sector. The Bank contributed with two Programmatic Financial and Public Sector Adjustment Loans,[17] for a total of $2.45 billion[18]—$1.25 billion on standard terms to support medium-term structural, policy, and institutional reforms in financial and public sectors that had been anticipated in the CAS but were accelerated in response to the crisis; and $1.2 billion on SSAL terms to support key up-front actions in the banking sector needed to reduce short-term vulnerabilities.[19] The approach reflected the original principle of the ESAL guidelines—that crises, and support for managing the responses to crises, are intrinsically unanticipated.

- ***Uruguay.*** Uruguay's crisis, which included a run on bank deposits, was brought about less by internal structural factors than by the cumulative impact of major external shocks.[20] Restoring confidence in the financial sector was key, but the Government also needed to start a program of reforms to address its long-term structural problem in public finance, both to restore market

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17 See Turkey: *Programmatic Financial and Public Sector Adjustment Loan* (R2001-123), June 21, 2001; and Turkey: *Second Programmatic Financial and Public Sector Adjustment Loan* (R2002-0047), March 26, 2002.

18 The two loans totaling $2.45 billion were part of a concerted international support package centered on an additional $8 billion in exceptional financing from the IMF, with the IMF program prepared in close cooperation with the Bank.

19 See *Turkey: Country Assistance Strategy Progress Report* (R2001-0113), June 29, 2001.

20 External shocks included contagion from the Argentinean crisis, currency devaluation by the two principal trading partners (Argentina and Brazil), capital market volatility affecting the country's large offshore banking business, and a disruption of meat exports due to foot-and mouth disease.

confidence and to set the stage for longer term fiscal sustainability. The Bank's support for the program included a SAL and an SSAL, presented to the Board in a single program document, for a total of about $250 million.[21] The SAL supported fiscal and social policy reforms that were already reflected in the original structural adjustment program supported by the Bank.[22] The SSAL supported financial sector reforms, with the first tranche recognizing the Government's emergency actions and the second tranche supporting reforms in the State Mortgage Bank.

9. ***Development Policy Lending.*** In August 2004, the Bank issued OP/BP 8.60 marking the transition from adjustment lending to development policy lending. One important aspect of moving to development policy lending was the Bank's recognition that its support for policy programs can be effective only if the country owns the programs.[23] Another highlight of the new policy framework was the consolidation of different types of policy-based loans into a single instrument called the development policy loan (DPL). The Bank retained its ability to provide DPLs with SSAL features by introducing the "option" of Special Development Policy Lending through an SDPL. Special Development Policy Lending is subject to the common policy framework for all development policy lending. Specifically, it serves the same purposes—helping the borrower address development financing requirements of domestic or external origin and achieve sustainable reductions in poverty through a program of policy and institutional actions that promote growth and enhance the well-being and increase the incomes of poor people.[24] For crisis support to serve these purposes, the financing needs brought on by the crisis must be urgent and extraordinary, the crisis must have substantial structural and social dimensions, and the program supported with Bank participation must include macroeconomic, social, and structural policies. This obviates the need for stating a separate rationale for crisis support.

10. ***SDPL Provisions.*** OP 8.60 incorporates the SSAL features regarding applicability, design and eligibility criteria, and financial terms (see paragraphs 24, 25, and 26), with the following modifications:

- ***Applicability.*** Paragraph 24 introduces the CAS lending envelope as an additional criterion: the Bank may, on an exceptional basis, provide Special Development Policy Lending "beyond the level set out in the CAS." It also clarifies that countries' financing needs in a crisis must be "urgent and extraordinary."

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[21] See Uruguay: *Structural Adjustment Loan and Special Structural Adjustment Loan* (R2002-0148), July 26, 2002. The two Bank loans were part of an international support package that included $2.24 billion from the IMF and $0.8 billion from the IDB.

[22] See *Uruguay: Country Assistance Strategy Progress Report* (R2002-0147), July 26, 2002; and *Uruguay: Country Assistance Strategy Progress Report—Update* (R2002-0147/1).

[23] See *From Adjustment Lending to Development Policy Lending: Update of World Bank Policy,* World Bank, Operations Policy and Country Services, August 2004; and *Adjustment Lending Retrospective* (SecM2001-0215), April 2, 2001.

[24] See OP 8.60, paragraphs 1 and 2.

- ***Eligibility.*** Paragraph 25 clarifies and strengthens the requirement of burden-sharing with the IMF, stating that "the country must have a *disbursing* IMF-supported program in place."

- ***Financial terms.*** Paragraph 26 maintains the provision that financial terms should reflect the special nature and high risks of lending for crisis support beyond anticipated levels. However, it removes the specific terms from the OP, instead referring to the Bank Treasury's website. Thus any future change in those terms does not require a change in OP 8.60.[25]

11. ***Early Consultations with the Board.*** BP 8.60 retains the SSAL Guidelines' commitment for Management to communicate early with Executive Directors on upcoming operations. Paragraph 3 states that for proposed Special Development Policy Lending, the Region consults informally with the Board at an early stage of preparation, and thereafter as necessary.

III. Proposed Revisions to the Policy Framework

12. The potential use of Special Development Policy Lending as an instrument for Bank participation in international rescue packages for countries in or approaching a crisis merits re-examination of the continued relevance and appropriateness of, and the need for, certain features. This includes the requirement that the country be in or approaching a crisis (i.e., not just be affected by the global crisis and recession), the requirement that SDPL support be beyond the lending level anticipated in the CAS, and the flexibility of financial terms with respect to maturity and pricing.

13. ***Financial and Economic Crisis.*** The global financial crisis and economic recession affects most IBRD-eligible countries, but only some of these countries are likely to experience characteristics of a financial and economic crisis, notably loss of confidence in the ability of the government, banks, or corporates to honor their obligations (see Box 1). The policy framework for Special Development Policy Lending limits the use of the instrument to Bank participation in international support packages for countries in or approaching crisis. This excludes its use for Bank response to the increasing demand for development policy lending from countries that encounter tightening financial markets or declining revenues because of the global financial crisis and economic recession, but are not themselves in or approaching a crisis that necessitates an IMF-led international rescue package. In such cases, incremental Bank development policy lending would replace other sources of financing that have become unavailable or too expensive, but would continue to support the country's programs of policy and institutional actions that have been laid out in the CAS. Management considers that, within the constraints of the Bank's risk capital allocation, other

[25] However, such changes would require modifications in OP 3.10 and OP 14.25 because these documents specify, respectively the financial terms for SDPLs and the fees for policy-based guarantees provided in association with Special Development Policy Lending support.

instruments such as regular Development Policy Lending and Development Policy Lending with a Deferred Drawdown Option are more suitable for responding to such demand, and that Special Development Policy Lending should continue to be limited to Bank participation in international support packages for countries in or approaching financial and economic crisis.

Box 1. What is a Crisis?

Crises are difficult to define. A note by the IMF highlights the following causes and characteristics of crises in emerging markets:

Crises in emerging markets can be caused by external or domestic factors. External causes comprise a collapse of export prices, a drastic increase in import prices, a shift in investor perceptions about risk that cause capital outflows, a large depreciation or devaluation of the currency of a close trading partner, a retrenchment of local activities of international banks, or a sharp curtailment of credit or increase in interest rates in world markets. Domestic causes include excessive monetary creation, unsustainable fiscal deficits, an overvalued domestic currency, political instability, and natural disasters. External shocks can have multiplying effects on vulnerable countries, which tend to have relatively high levels of private or public debt, weak financial systems, and a history of instability and inappropriate policies. These factors often coincide, magnifying the depth and the breath of a crisis. All crises are therefore marked by a sudden worsening of perceptions about country's prospects, often including the ability of the government, banks, or corporations to honor their obligations. The ensuing loss of confidence precipitates deleveraging of financial contracts, a collapse of domestic asset prices, and downward pressure on the value of the domestic currency.

Source: *Crisis Lending and the IMF,* www.imf.org/external/np/exr/facts/crislend.htm, A Factsheet – February 2009.

14. ***Relation to the CAS.*** Financial crises are intrinsically unanticipated, i.e., Special Development Policy Lending cannot be part of the CAS, except when the CAS is updated or a new CAS is issued during a crisis. With the CAS normally comprising the Bank's noncrisis support for a country's development efforts, OP 8.60 sought to provide a benchmark for the use of Special Development Policy Lending by specifying that it is lending "beyond the level set out in the CAS" (paragraph 24) and that it requires nonstandard (SDPL) terms for being crisis support "beyond anticipated levels" (paragraph 26). But these specifications can serve as a useful benchmark only when the CAS lending envelope represents the total non-crisis financial support the Bank is prepared to provide to the country's development efforts—that is, when the borrower's anticipated lending demand equals or exceeds the amount the Bank is prepared to supply.[26] Management believes that, for several reasons, the specifications are no longer relevant and are not necessary to guide the use of SDPLs.

- ***Relevance.*** The content of CASs and the significance of the CAS lending envelope have evolved. All CASs are expected to set out the areas of the government's development programs that merit Bank support over the three or four years of the CAS period, and to indicate the amount of lending and other Bank services. In many middle-income countries that had gained access to

[26] Unlike in IDA-eligible countries, where the Bank provides funding on concessional terms, this is not necessarily the case with nonconcessional lending to IBRD-eligible countries.

capital markets at good terms or could rely on their own resources, demand for IBRD funds had fallen well below the amount the Bank would be willing to provide on the basis of the country's credit risk and the strength of the government's program. Demand for Bank services also often varies over the CAS period, as country conditions and government priorities change. As a result, in most IBRD-eligible countries the level of lending set out in the CAS reflected an estimate of the country's demand made at the time of CAS preparation, with the Bank prepared to respond if higher (or lower) lending demand emerged during the CAS period. The CAS lending envelope therefore became irrelevant as a benchmark for Special Development Policy Lending.

- ***Necessity.*** The link to the CAS lending envelope is unnecessary to regulate the use of SDPL, especially since OP 8.60 clearly sets out the necessary conditions for such lending in paragraphs 24-26. The conditions appropriately focus on the nature of the country's financial crisis and on the required international support, rather than on the estimated level of demand for lending over the CAS period. Special Development Policy Lending requires that all of the following criteria be met:

  - The country must be approaching or in a crisis and have urgent and extraordinary financing needs. (This implies that any support through Special Development Policy Lending is unanticipated.)
  - The country must have a disbursing IMF-supported program in place and Special Development Policy Lending must be part of an international support package. (Together this implies that the country must be facing a crisis that requires an IMF-led international rescue package.)
  - The crisis must have substantial structural and social dimensions and the international support package in which the Bank participates must be one of structural, social, and macroeconomic policy, with conditionality embedded in a strong policy program. (This implies that areas of the Bank's mandate and comparative advantage are necessary to help the country design and implement a program that restores market confidence.)
  - Furthermore, OP 8.60 states that Special Development Policy Lending is provided only on an exceptional basis. In addition, it requires that the Bank determine that the country's external financing plan is sustainable and the SDPL and its associated debt service are within debt sustainability limits, that the magnitude of the SDPL be subject to the availability of adequate IBRD financial and risk-bearing capacity, and that its financial terms reflect the special nature and high risks of lending for crisis support.

15. ***Removal of the CAS Benchmark.*** Because the provision is not relevant and the necessary conditions for the use of Special Development Policy Lending are clear, Management proposes deleting without substitution the references to "lending beyond the level set out in the CAS" and to crisis support "beyond anticipated levels" in paragraphs 24 and 26, respectively, of OP 8.60. Special Development Policy Lending would

continue to be a rarely used instrument for Bank participation in IMF-led international rescue packages for countries experiencing a financial crisis. The Bank would retain its ability to participate in rescue packages by supporting reforms anticipated in the CAS (and possibly brought forward because of the crisis) with development policy lending at standard terms, as it did in Turkey and Uruguay. More broadly, the choice between the use of a regular DPL or SDPL option would continue to be guided by the requirement that Special Development Policy Lending be used on an "exceptional basis", as stated in paragraph 24 of OP 8.60. Pertinent considerations to that end may include: to what extent is the Bank engaged in the country's development program and maintains a policy dialogue with the government on the country's development challenges and the key components of the government's development program; would the Bank provide the loan if it had not been called upon to participate in the IMF-led rescue package; to what extent does the loan further the country's medium-term development agenda in addition to helping the government manage its response to the crisis; and how substantial is the loan's adverse impact on IBRD's ability to support the core development agenda of its members.

16. ***Financial Terms.*** The financial terms of SDPLs are stated on the Treasury website and are also specified in OP 3.10. These terms, particularly the shorter maturity and higher pricing relative to normal loans, would continue to reflect the special nature and high risks of lending for crisis support. However, within the foregoing approach, the specific financial terms applicable to SDPLs are proposed to be modified to allow additional flexibility with regard to repayment terms as well as to ensure that the Bank's charges for SDPLs remain broadly aligned to those of the IMF. Other financial terms applicable to regular Bank loans, including with respect to conversion options, will continue to be offered for SDPLs.

- ***SDPL Maturity***. The relatively shorter maturity of SDPLs is intended to mitigate concerns relating to crowding out of other borrowers and the possible adverse impact on the credit standing of the Bank for a longer period of time. However, management believes that flexibility in SDPLs repayment terms would help to avoid the possibility of significant repayment pressure on borrowers while the crisis is yet to be resolved. The ability to tailor loan repayment terms to the specific circumstances of the crisis-affected country is particularly useful for IBRD, whose reliance (unlike the IMF) on capital markets for raising debt constrains the Bank's ability to roll-over loans for borrowers facing large repayments while still in financial distress. Management proposes to make the SDPL repayment terms more flexible by changing the 3-year grace period to a 3-5 year grace period, and changing the 5-year final maturity to a 5-10 year final maturity.

- ***SDPL Pricing.*** As noted earlier, the current SDPL pricing of LIBOR+400 basis points, formulated originally in 1998 for ESALs, took into account the IMF's terms for access to its Supplemental Reserve Facility (SRF), which was the IMF's primary emergency lending window in the aftermath of the Asian crisis. In the current crisis, however, the IMF's primary window for emergency lending has been 'Credit tranches', which are priced cheaper than

the SRF (the SRF was recently eliminated by IMF: see Annex 2 for details). Given the differences in currencies, repricing benchmarks, and most importantly the proposed longer maturities of SDPLs relative to IMF crisis loans, SDPL pricing is not amenable to a precise comparison with IMF's pricing of crisis loans. Notwithstanding the foregoing, management has taken note of the reduction in the pricing of IMF emergency assistance and proposes to reduce the minimum fixed spread (over LIBOR) on SDPLs from 400 bps to 200 bps in order to maintain broad comparability to the IMF's terms. The front-end fee is proposed to be maintained at 100 bps.

- ***Guarantee Pricing.*** The Bank's Operational Policy 14.25, *Guarantees,* provides for special charges for policy-based guarantees that are provided as a part of a Special Development Policy Lending support package. Based on the principle of loan equivalency, the guarantee fee for such guarantees will equal the spread over LIBOR charged for the SDPL, there will be no standby fee, and the front-end fee will be maintained at 100 bps.

IV. RECOMMENDATION

17. Based on this policy paper, Management recommends that the Executive Directors approve the following changes for SDPLs and related policy-based guarantees:

(a) the elimination of the existing linkage between Special Development Policy Lending and a country's CAS lending envelope under the Bank's operational policy framework for development policy lending

(b) the introduction of greater flexibility in SDPL repayment terms and revisions to SDPL pricing as below:

i. a grace period of 3-5 years with a final maturity of 5-10 years;

ii. a minimum fixed spread over LIBOR of 200 bps; and

iii. A front-end fee of 100 bps.

(c) Revised financial terms for policy-based guarantees issued in connection with SDPLs comprising of a front-end fee of 100 bps, no standby fee, and guarantee fee equal to the spread over LIBOR charged for the SDPL.

18. ***Next Steps.*** If Executive Directors approve Management's recommendation, Management will make appropriate revisions to OP and BP 8.60, *Development Policy Lending*, OP 3.10, *Financial Terms and Conditions of IBRD Loans, IBRD Hedging Products, and IDA Credits*, and OP 14.25, *Guarantees*.

SPECIAL DEVELOPMENT POLICY LENDING: PROPOSED MODIFICATION OF OP 8.60 AND TREASURY WEBSITE

OP 8.60 current text	*OP 8.60 new text*
Para. 24. For IBRD-eligible countries that are approaching or are in a crisis with substantial structural and social dimensions, and that have urgent and extraordinary financing needs, the Bank may, on an exceptional basis, provide Special Development Policy Lending beyond the level set out in the CAS. The magnitude of such financial support is subject to the availability of adequate IBRD financial and risk-bearing capacity.	Para. 24. For IBRD-eligible countries that are approaching or are in a crisis with substantial structural and social dimensions, and that have urgent and extraordinary financing needs, the Bank may, on an exceptional basis, provide Special Development Policy Lending. The magnitude of such financial support is subject to the availability of adequate IBRD financial and risk-bearing capacity.
Para. 25. *Design and Eligibility Criteria.* To be eligible for Special Development Policy Lending, the country must have a disbursing IMF-supported program in place. Special Development Policy Lending must be part of an international support package—which may include multilaterals, bilateral donors, and private lenders and investors—of structural, social, and macroeconomic policy, with conditionality embedded in a strong policy program. The Bank determines that the country's external financing plan is sustainable, and ascertains that the Special Development Policy Lending and its associated debt service are within medium-term debt sustainability limits. A Special Development Policy loan may have one or more tranches.	Para. 25. *Design and Eligibility Criteria.* To be eligible for Special Development Policy Lending, the country must have a disbursing IMF-supported program in place. Special Development Policy Lending must be part of an international support package—which may include multilaterals, bilateral donors, and private lenders and investors—of structural, social, and macroeconomic policy, with conditionality embedded in a strong policy program. The Bank determines that the country's external financing plan is sustainable, and ascertains that the Special Development Policy Lending and its associated debt service are within medium-term debt sustainability limits. A Special Development Policy loan may have one or more tranches.
Para. 26. *Financial Terms.* The financial terms of Special Development Policy Lending reflect the special nature and high risks of lending for crisis support beyond anticipated levels.[19]	Para. 26. *Financial Terms.* The financial terms of Special Development Policy Lending reflect the special nature and high risks of lending for crisis support.[19]

TREASURY WEBSITE PROPOSED TEXT

The Special Development Policy loan (SDPL) supports structural and social reforms by creditworthy borrowers that are approaching a possible financial crisis, or already in crisis, and that have extraordinary and urgent external financial needs. Borrowers seeking SDPLs must have a disbursing IMF-supported program in place, and be seeking Bank lending as part of a concerted international support package. SDPLs help countries to prevent a crisis or, if one occurs, to mitigate its adverse economic and social impact. The SDPL confers the same flexibility to borrowers as the IBRD Flexible Loan (IFL) to manage interest rate and currency risk. However, SDPLs have different terms than the IFLs. They carry a 5- to 10-year final maturity, a 3- to 5-year grace period, a *minimum* loan spread of 200 basis points over LIBOR, and a front-end fee of 1 percent of the principal loan amount.

IMF PRICING

1. The table below summarizes the financial terms of the 'Credit tranches' used by IMF to provide expanded assistance in the current crisis, compared with the terms of the Supplemental Reserve Facility (SRF), which was the primary instrument used by IMF in the Asian crisis. As part of recent reforms that aim to better equip IMF to respond to the current crisis, the Fund has revised its pricing and eliminated the SRF.

IMF Terms: Credit tranches v/s SRF[1]

Instrument	Interest*	Average Maturity
Credit tranche		4 years
Up to 300% of quota	Basic Rate**	
Over 300% of quota	Basic Rate+2%, with a 1% surcharge beyond 3 years	
SRF (used in Asian crisis, no longer offered)	Basic Rate+3%-5% *(Spread over basic rate starts at 3% and rises 50 bp after 1 year and each subsequent 6 months)*	2.25 years

* In addition to interest, IMF charges a service fee of 0.5% and a commitment fee of 15 bps up to 200% of quota, 30 bps for 200%-1000% of quota and 60 bps in excess of 1000% of quota.

** The rate of charge is currently set about 100 bps above the SDR interest rate. The SDR rate is the average interest rate on short-term government securities, weighted by the share of the respective currencies in the SDR.

2. In the aftermath of the Asian crisis the bulk of emergency funding from IMF was through the SRF, which carried a loan charge of approximately LIBOR+400bps. In the current crisis however, expanded access to borrowers of IMF crisis loans has been through 'Credit tranches'. Subsequent to a reform of its charges adopted recently, IMF has two Credit tranches: (i) one tranche up to 300% of quota priced at the Basic Rate and (ii) a second tranche for over 300% of quota priced at Basic Rate+2% for the first 3 years and Basic Rate+3% beyond 3 years. An IMF borrower's average loan charges will vary depending upon the proportions of the first and the second Credit tranches and the repayment period. However, most emergency loans from IMF are expected to have a substantial proportion of the higher-priced Credit tranche, given that 300% of the IMF quota constitutes a relatively small part of the financing requirements of a country in need of emergency funding.

3. IMF's pricing is not amenable to a precise comparison with SDPL pricing due to the following differences:

- Repricing indices/frequency: IMF's index is the SDR interest rate, which is a measure of the interest rate on short-term government securities issued by (US, Euro-area, UK, and Japan) and reset weekly, while IBRD's index is 6-month

[1] Incorporates changes in IMF terms adopted as part of recent reforms.

LIBOR, which is a measure of major banks' borrowing cost and reset semesterly.

- Currencies: IMF's loans are denominated in SDR (basket comprising US Dollar, EURO, Japanese Yen and the Pound Sterling), while IBRD's loans are denominated in a single currency, such as US Dollar.

- Maturities: IMF's Credit tranches have a maximum average maturity of 4 years. The proposed maximum average maturity of SDPL is significantly higher at about 7.5 years. It is notable that there is substantial value attached to longer maturities during periods of market turmoil across all borrowers, but particularly so for distressed ones.

Notwithstanding the above, a broad equivalence to the pricing of IMF's highest-priced Credit tranche (priced at Basic Rate+200 bps, or SDR+300 bps, excluding the 1% surcharge beyond 3 years) would translate to approximately LIBOR+200 bps on a swap-equivalent basis.