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CHANGES TO THE FUND'S FINANCING ASSURANCES POLICY IN THE CONTEXT OF FUND UPPER CREDIT TRANCHE FINANCING UNDER EXCEPTIONALLY HIGH UNCERTAINTY

IMF staff regularly produces papers proposing new IMF policies, exploring options for reform, or reviewing existing IMF policies and operations. The following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its March 15, 2023 consideration of the staff report.
- The **Staff Report**, prepared by IMF staff and completed on March 2, 2023 for the Executive Board's consideration on March 15, 2023.

[The documents listed below have been or will be separately released.]

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International Monetary Fund
Washington, D.C.

IMF Executive Board Concludes Changes to the Fund's Financing Assurances Policy in the Context of Fund Upper Credit Tranche Financing Under Exceptionally High Uncertainty

FOR IMMEDIATE RELEASE

Washington, DC – March 17, 2023: The Executive Board of the International Monetary Fund (IMF) approved changes to the Fund's financing assurances policy. The changes apply in situations of exceptionally high uncertainty, involving exogenous shocks that are beyond the control of country authorities and the reach of their economic policies, and which generate larger than usual tail risks.

In situations of exceptionally high uncertainty, the Fund can provide emergency financing to meet urgent Balance of Payments (BoP) needs of members, provided certain safeguards are met. It is more challenging to provide support through an Upper Credit Tranche (UCT) arrangement, which requires a Fund-supported program that resolves BoP problems, restores external viability over the medium term, and provides adequate safeguards.

The changes adopted would address key barriers to designing a Fund UCT program in situations of exceptionally high uncertainty, in particular by modifying the Fund's financing assurances policies in two ways. The first change allows official bilateral creditors to provide an upfront credible assurance about delivering debt relief and/or financing with the delivery of a contingent second-stage element of debt relief and/or financing once the exceptionally high uncertainty has been resolved. This would help establish that medium-term viability is being restored. The second change extends the use of a capacity-to-repay assurances from official bilateral creditors/donors from emergency financing to a UCT arrangement context. This would help establish adequate safeguards.

These changes and their application to any specific country case in a situation of exceptionally high uncertainty would require the Fund to weigh enterprise risks. Therefore, along with these changes, the Board also established a procedural safeguard for early consultation with Executive Directors about engagement under exceptionally high uncertainty to determine whether these circumstances are present and whether the Fund is prepared to accept the risks that a UCT arrangement would entail.

Executive Board Assessment:

Executive Directors welcomed the opportunity to consider reforms to the Fund's Financing Assurances Policy that would enable the approval of upper credit tranche Fund arrangements (UCT arrangements) in cases of exceptionally high uncertainty. Directors stressed that emergency financing through the Rapid Financing Instrument and/or Rapid Credit Facility would generally be the appropriate modality for the Fund to support members with urgent balance of payments (BOP) needs in the context of exceptionally high uncertainty. However, stronger Fund engagement in a UCT context with a member facing exceptionally high uncertainty might be deemed appropriate and consistent with Fund policies in certain cases.

Directors agreed that a case of "exceptionally high uncertainty" is characterized by all of the factors set out in paragraph 13 of the paper. Directors stressed that the assessment of whether a case is one of "exceptionally high uncertainty" must be made in a manner that ensures uniformity of treatment and evenhandedness across the membership.

Directors recognized that it is extremely difficult to design a UCT-quality arrangement in cases of exceptionally high uncertainty. They supported the approach detailed in the paper of setting out two fully elaborated scenarios in such cases, covering both a baseline and a downside scenario, noting the need to demonstrate that a Fund-supported program could work in both scenarios, and that these scenarios would need to be sufficiently separated to generate confidence that the program could succeed and solve the member's BOP problem and restore the member to medium-term external viability, notwithstanding the exceptionally high uncertainty about the ongoing shock. Directors stressed that a member would need to have the capacity and commitment to implement a UCT arrangement in such circumstances and to provide the necessary data for the Fund to be able to monitor the program, and that a Staff Monitored Program or Program Monitoring with Board involvement might first be necessary to establish a track record on this.

Directors stressed that proceeding with a Fund-supported program in cases of exceptionally high uncertainty would require careful judgment about whether such a program would be feasible and credible given its likely risk characteristics, and be consistent with legal and policy requirements for Fund lending. These requirements include providing adequate confidence about the ability of the program to solve the member's BOP problem and restore the member to medium-term external viability, while providing adequate safeguards for the repayment of the Fund's financing. The Board would need to make this judgement, based on a recommendation from Management and staff, at the time of approval of the arrangement as well as at subsequent reviews. Directors expected that, to the extent the exceptionally high uncertainty dissipates, the program design would revert to the standard Fund approach to lending built just around the baseline. In the event that the circumstances of exceptionally high uncertainty were to deteriorate and questions arose about whether the level of confidence had become too low to clearly and credibly establish a program design to resolve the member's BOP problem and/or restore debt sustainability, then Directors would need to determine whether further financing under the arrangement would become infeasible.

To support the Fund's ability to approve UCT arrangements in cases of exceptionally high uncertainty, Directors endorsed the use of a procedural safeguard set out in paragraph 18 of the paper for an initial engagement with Executive Directors. Some Directors called for a broader engagement than set out in the paper, with a few Directors calling for a formal Board meeting.

Directors also supported two policy modifications, applying only to cases of exceptionally high uncertainty, to allow UCT arrangements. First, Directors supported the modified approach in cases of exceptionally high uncertainty set out in paragraph 25 of the paper for official bilateral creditors to deliver credible upfront assurances covering their commitments to help restore debt sustainability where contributions from official bilateral creditors are needed to restore debt sustainability. Directors also endorsed the proposal set out in paragraph 26 of the paper, for situations of exceptionally high uncertainty, to extend the existing use of a capacity-to-repay assurance from official bilateral creditors/donors to ensure adequate safeguards for the repayment of the Fund's financing from an emergency financing context to a UCT program context.

Directors welcomed the paper's discussion of risks and noted that the proposed policy changes involve considerable enterprise risks to the Fund while also noting the mitigants to address these risks identified in the paper. However, they generally agreed that when considering these risks—including reputational and spillover risks—the benefit of having the option of supporting members facing exceptionally high uncertainty outweighs the additional risk of the proposed policy change.

March 2, 2023

CHANGES TO THE FUND'S FINANCING ASSURANCES POLICY IN THE CONTEXT OF FUND UPPER CREDIT TRANCHE (UCT) FINANCING UNDER EXCEPTIONALLY HIGH UNCERTAINTY

EXECUTIVE SUMMARY

The Fund may on occasion confront cases of member countries requesting Fund financing which face exceptionally high uncertainty. Such situations are complex, but generally involve exogenous shocks beyond the authorities' control and the reach of their economic policies, at least in the near term. Fund engagement in situations either meeting this description or sharing some features of it has been rare, with three past examples of Fund engagement post-2000, all addressed through emergency financing.

An RFI/RCF would be the appropriate instrument for the Fund to support members with urgent BOP needs in the context of exceptionally high uncertainty. Providing Fund Upper Credit Tranche (UCT) financing would implicate two conditions under the Fund's legal and policy frameworks. First, a program would need to be designed to solve the member's balance of payments (BoP) problem and achieve medium-term external viability; and second, adequate safeguards would need to be in place for the Fund's lending, including capacity to repay the Fund. Debt must thus be sustainable on a forward-looking basis. Usually, the UCT program is designed with sufficient confidence that the program will succeed and will also in itself provide adequate safeguards, but the tails risks associated with such exceptionally high uncertainty means that confidence is lower than normal that the program can in itself deliver this.

Stronger Fund engagement in a UCT context with a member facing exceptionally high uncertainty could nonetheless be appropriate. This paper proposes: (i) a procedural safeguard on early Board consultation about engagement, given elevated risks to the Fund; and (ii) two reforms to the Fund's financing assurances policy to enable the Fund to proceed with UCT financing despite such exceptionally high uncertainty. The first would be to allow upfront commitment to debt relief with a contingent second-stage element. The second would be to extend the use of a capacity-to-repay assurance from official bilateral creditors/donors from emergency financing to a UCT context. The changes would together facilitate adequate safeguards in situations involving exceptionally high uncertainty, in line with the Fund's legal and policy frameworks.

These proposed policy changes and their application to any specific country case involving exceptionally high uncertainty would result in the Fund taking on material additional enterprise risks. These need to be carefully weighed, as identified mitigating factors would only partially reduce them.

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INTRODUCTION

1. **The Fund may on occasion confront cases of member countries requesting Fund financing while facing exceptionally high uncertainty.** Such situations are complex, and can be described in simple terms as involving exogenous shocks that are beyond the authorities' control and the reach of their economic policies, such as, but not necessarily limited to, a large-scale war (Section III defines the situation more precisely). An RFI/RCF would be the appropriate instrument for the Fund to support members with urgent BOP needs in such context. These cases have been comparatively rare. A clear example is Ukraine (2022). Iraq (2005) and Lebanon (2007) shared some of the features. All three of these cases were indeed addressed through emergency financing.

2. **Fund UCT financing may be feasible in situations of exceptionally high uncertainty, under the proposals put forward in this paper.** However, such an engagement would involve elevated risks for the Fund, and as such the paper proposes a procedural safeguard for prior Board consultation on whether the circumstance exists and whether the Fund would be prepared to accept such risks and pursue a UCT program with a requesting member.

3. **Designing Fund UCT financing under such circumstances would entail two separate, but related, key challenges that would need to be assessed and addressed in line with the Fund's legal and policy frameworks.** It would require, first, designing a program that will solve the member's balance of payments (BoP) problem and achieve medium-term external viability; and second, securing adequate safeguards, including an assessment that the member has capacity to repay the Fund. Both of these require an assessment that debt is sustainable on a forward-looking basis.

4. **This paper outlines two changes to the Fund's financing assurances policy that would allow the Fund to proceed with a UCT program despite such exceptionally high uncertainty.** These proposed changes would first provide for a modified way for a set of official bilateral creditors to deliver upfront credible assurances covering their commitments to help restore debt sustainability. Second, they would allow for the possibility for a set of creditors and donors (as necessary) to provide to the Fund a credible assurance about the member's capacity to repay in a UCT lending context (thus going beyond the current use of this approach in an emergency financing context).

5. **This paper is structured as follows:** Section II outlines the Fund's current policy on financing assurances as background. Section III explains exceptionally high uncertainty in more detail and when the Fund may wish to go beyond its standard approach in such circumstances. Section IV covers the problems it creates for designing a UCT program, and how such problems could be overcome. Section V then outlines how the program solution poses a challenge for the Fund's financing assurances policy and discusses two proposed changes that could facilitate Fund engagement. Section VI discusses enterprise risks and mitigating factors. Section VII outlines issues for discussion.

WHAT IS THE FUND'S CURRENT FINANCING ASSURANCES POLICY?

6. The Fund's Articles of Agreement and long-standing policy and practice set forth the basic conditions that must be met for the Fund to approve a UCT Fund arrangement.[1] A Fund arrangement is supported by the member's macro-economic adjustment program (Fund-supported program). The member must have the capacity and commitment to implement the Fund-supported program, and the Fund must be able to monitor implementation of the program (which requires that the member have the ability and willingness to provide timely and accurate data to the Fund). Management may not recommend, nor the Board approve, a new arrangement or completion of a review under an arrangement unless two separate but related conditions are met:

- Fund-supported programs must be designed with the goal to solve the member's BoP problem and achieve medium-term external viability.[2] As such, the Fund may only approve an arrangement where it is satisfied that the Fund's resources will be used to help the member resolve its BoP problems in a manner consistent with the Articles.[3] This requires an assessment that the member is implementing policies that will address—rather than simply delay—the resolution of its external difficulties.

- The Fund may only lend under adequate safeguards.[4] This includes, at base, a judgment that the member will be in a position to repay the Fund as required under the Articles.

These two conditions underpin the Fund's ability to perform its crisis lending role. They are separate but related, as resolution of the member's balance problem has been understood as the most effective means to ensure its capacity to repay the Fund in a UCT context.[5]

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[1]Fund arrangements are decisions of the Executive Board by which the member is assured that it will be able to make purchases or receive disbursements from the Fund in accordance with the terms of the decision during a specified period and up to a specified amount. Fund arrangements are not contracts.

[2]Article V, 3(a) and paras. 5 and 6 of the Guidelines on Conditionality. The more specific goals under Paragraph 6 of the Guidelines on Conditionality are solving the member's balance of payments problem "without recourse to measures destructive of national or international prosperity", and achieving medium-term external viability "while fostering sustainable economic growth".

[3]Article I sets out the Fund's purposes. UCT quality programs supported by the Poverty Reduction and Growth Trust (PRGT) aim to help members make significant progress toward a sustainable macroeconomic position.

[4]Article V, 3(a).

[5]See *Criteria for the Amount of Access in Individual Cases* ("adjustment policies in support of which the Fund's resources are to be used must be designed and implemented in such a manner as to lead to a strengthening of the balance of payments by the time the repurchases begin to fall due and of a sufficient extent to allow the member to make the repurchases without strain.") See also *"2018 Review of Program Design and Conditionality"* ("Programs supported by GRA resources are designed to resolve the member's BoP problem during the program period. In contrast, the purpose of programs supported by the Extended Credit Facility is to help PRGT-eligible members with protracted BoP problems implement their economic programs and make significant progress toward a stable and sustainable BoP").

7. Consistent with these requirements, where a member's debt is assessed as unsustainable, the Fund is precluded from providing financing unless the member takes steps to restore debt sustainability. A combination of policy adjustment and financing from public and private sources is normally sufficient when debt is assessed as sustainable in a Fund-supported program. There are circumstances, however, where the member's debt level is assessed as "unsustainable", i.e., where the scheduled debt service exceeds the capacity of the member to service it, even taking into account both a strong adjustment program and significant financial support from the Fund. Lending in such circumstances without corrective actions by creditors is not possible as the member would not be able to resolve its BoP problem and regain medium-term external viability (which is closely linked to debt sustainability) and the Fund would lack adequate safeguards.

8. The Fund's financing assurances policy is an integral element of ensuring that these conditions for Fund lending under a UCT arrangement are met. Under the Fund's financing assurances policy, the Fund must be satisfied that program financing is adequate to fill financing gaps during the program period to ensure external viability and to ensure that the member is in a position to repay the Fund during the post-program period. Specifically, this requires that in the event that there are gaps with respect to new external financing to be provided by the official sector: (i) "firm commitments" of financing must be in place for the upcoming 12 months of the arrangement, and (ii) "good prospects" that there will be adequate financing for the remaining program period beyond the upcoming 12 months. With respect to the post-program period, staff needs to assess whether the member's prospective policies and financing deliver a projected post-program macroeconomic performance that adequately safeguards repayments to the Fund consistent with a sustainable debt as well as to ensure that the member is in a position to repay the Fund during the post-program period.[6] Together with the policy commitments made by the member, these assurances help establish that the BoP problem will be resolved and medium term external viability restored with adequate safeguards.

9. The form of financing assurances to restore debt sustainability sought by the Fund depends on the nature of the creditors. With respect to official bilateral creditors, in the absence of a restructuring agreement, the Fund requires "specific and credible" assurances that debt relief and/or new financing will be provided on a sufficient scale to restore debt sustainability and close financing gaps, consistent with program parameters.[7] When a contribution from private creditors is required to restore debt sustainability and to close financing gaps, assurances are derived from the Fund's judgment that a credible process for debt restructuring is underway and such debt

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[6]For a detailed description of the Fund's policy on financing assurances, see *Reviews of the Fund's Sovereign Arrears Policies and Perimeter,* Annex I, available here (hereinafter, the "Arrears Paper").

[7]*Id*. These specific and credible assurances should preferably take the form of a written communication from the official bilateral creditor showing an understanding of the debtor member's situation and a commitment to the needed actions to restore debt sustainability and financing in line with program parameters. For Paris Club creditors, credible and specific assurances on debt relief and/or financing generally take the form of a preliminary indication that the Paris Club is willing to provide debt relief in anticipation of an Agreed Minute.

restructuring will likely deliver an outcome in line with program parameters.[8] It is important to note that the Fund does not require that creditor actions go beyond what is necessary to restore sustainability, and cannot do so as the Fund's financing is to assist the member to address its BoP problem under adequate safeguards, not to engineer extra transfers from creditors to the member.[9]

10. While financing assurances must be provided by official bilateral creditors prior to approval of a Fund arrangement, the delivery of debt relief may take longer. Under current policy, official bilateral creditors provide financing assurances based on the Fund's baseline scenario that underpins the Fund-supported program and the DSA, and this allows the Fund to determine that, by the end of the program period, debt sustainability will be definitively restored. Normally, it has taken creditors 6-9 months after program initiation to formally complete the needed contractual modifications for debt relief. However, there are some cases where creditors can commit upfront to the full relief, with a flow treatment helping to finance the program; and delivery of the pre-committed definitive treatment later on before the end of the arrangement. The Highly Indebted Poor Countries (HIPC) relief initiative is an example of such an approach (with the delayed debt treatment in that context being intended to motivate debtor country reforms geared towards required policy reforms).

11. Overall, the Fund has a good track record in relying on assurances provided by creditors/donors in the context of its lending operations. While such assurances are not a legally binding guarantee, they are an integral part of the design of UCT programs and play an important role in ensuring adequate safeguards for Fund lending.

WHAT IS EXCEPTIONALLY HIGH UNCERTAINTY AND WHAT WOULD MOTIVATE FUND UCT PROGRAM INVOLVEMENT?

12. Fund UCT lending amid high uncertainty has precedents. UCT-quality programs have been designed under various degrees of uncertainty, including during the Global Financial Crisis, pandemic, conflict, and post-conflict. In all of these circumstances, the authorities' economic policies were deemed capable of addressing the BoP problem and tail risks were seen as contained, underpinning a standard Fund program approach built around a central scenario.

13. Exceptionally high uncertainty is a different situation. It is characterized by a combination of several factors:

[8]As described in the Arrears Paper, in cases where there are significant uncertainties that the creditor(s) will restructure their claims (e.g., the debt is collateralized and/or there is a high legal risk that creditor action could severely undermine program implementation) and such restructuring is critical to achieving debt sustainability and medium-term viability, the Fund may need to seek further assurances from the creditor(s).

[9]In exceptional access cases, the requirement is to restore debt sustainability with high probability.

- It originates in an exogenous shock; that is, an ongoing shock to a members' economic capacity that originates in factors beyond the authorities' control.
- The impact of the shock on the economy depends on events fundamentally outside of the control of the authorities' economic policies, at least in the near-term.
- Thus, it involves severe and continuing balance of payment impacts, making the scale of the BoP challenge difficult to assess with the usual degree of confidence associated with UCT lending (although there could still be a credible basis for assessing that UCT requirements are met as discussed below). An example is a shock in the form of a large-scale war.
- No one scenario that characterizes the evolution of the ongoing shock can be seen as sufficiently "central", and indeed the situation involves significant adverse tail risks where the shock and/or its impacts could continue beyond the usual Fund program timeframe.
- The ability of official bilateral creditors to ensure debt sustainability through upfront debt write-downs is impaired due to the lack of a sufficiently "central" scenario and given the presence of large downside risks, and broader sources of financing must be catalyzed to help resolve the BoP problem.

14. A country experiencing exceptionally high uncertainty, as defined above, could be a fragile state, although not necessarily so. Fragile and conflict affected states may be facing extended institutional and social fragility from a broad range of issues, and these deeply rooted fragilities are often first and foremost about domestic fragility, not necessarily stemming from events beyond their policy control. There is typically sufficient confidence in a baseline scenario to guide a UCT program in a fragile and conflict affected state.[10]

15. The Fund should handle a circumstance of exceptional uncertainty through convening donor support and through emergency financing if conditions are met. The Fund can catalyze donor support by helping the member implement a policy framework, e.g., through program monitoring with Board involvement (PMB). The Fund can also establish and administer trust accounts. Where adequate safeguards can be established, the Fund can also provide for emergency financing if conditions are met (outright purchases of this form do not involve the same requirements for resolving BoP problems due to the urgent need). Indeed, the Fund has previously provided such emergency financing in Ukraine (2022), a case fitting the definition. This was also the approach in Iraq (2005) and Lebanon (2007), which shared some features of this type of uncertainty. Safeguards were established in all these instances through a capacity-to-repay assurance from creditors and donors.

16. There are no precedents for Fund GRA or PRGT UCT lending under exceptionally high uncertainty, as defined above. The situation would almost certainly involve large BoP gaps

[10]In such instances, the Fund's FCS Strategy covers the Fund's long-term engagement strategy and how the Fund can better integrate its different dimensions (lending, surveillance and CD) and partnerships (making the best of the different types of expertise other institutions have).

extending for some period. However, it implies a lower degree of confidence than normal that the program will resolve the BoP problems and restore medium-term external viability, and indeed it is possible that economic policies will not be able to resolve the BoP problems, pointing to very significant safeguards concerns for Fund resources. The Fund's multi-layered risk management framework has elements in place that would help mitigate any credit concerns that may arise ex-post.[11] However, the strength of a UCT program is the most critical safeguard for a Fund program under the Fund policies and any Fund lending requires that adequate safeguards are in place already when new financing is approved by the Board (and when each program review is completed).

17. However, Fund GRA or PRGT UCT lending might be deemed appropriate and consistent with the Fund's policy despite the exceptionally high uncertainty. These situations would require stronger safeguards than the assurances given in an emergency financing context, in view of the more demanding objectives set for a UCT program, the need to protect the Fund's "seal of approval" implied by UCT programs, and the higher access under such arrangements.

18. In view of the risks of engaging in UCT lending under exceptionally high uncertainty, as defined above, a procedural safeguard is proposed. Engaging in such circumstances would involve a material increase in risks to the Fund (as discussed further below in Section VI). For a member facing such uncertainty initial Board engagement would be expected in the context of convening creditor and donor support or emergency financing. The Board would need to consider the issue of whether exceptionally high uncertainty, as defined above, exists, and whether the Fund would be prepared to accept higher risks, and pursue a UCT arrangement, if the member had requested it at that point. The international community may wish to have a more structured framework in place to catalyze broader support for such a member, for example due to concern about global risks from spillovers from that members' situation.[12] To the extent the issues were not covered in initial engagements, or a request for UCT financing from the member had been subsequently received, a dedicated Board meeting could be called to consider these issues.

CAN A UCT PROGRAM BE SPECIFIED IN SITUATIONS OF EXCEPTIONALLY HIGH UNCERTAINTY?

19. While Fund policies do not rule out UCT lending under exceptionally high uncertainty, it is inherently difficult to satisfy the necessary conditions for such lending. This situation by definition would involve a much higher variance around a baseline scenario, with a fatter tail risk of

[11]The key elements of the Fund's multilayered framework for managing credit risks related to (GRA) lending include: program design and conditionality, lending policies, Post Financing assessments, the Fund's de facto preferred creditor status, the cooperative arrears management strategy, the burden sharing mechanism, and precautionary balances.

[12]For instance, the member in question could be deeply integrated into financial markets or have concentrated enough positions in global production or value chains such that not providing large financing to assist it would have significant global risks.

adverse outcomes, including a high chance that the program could outright fail. Thus, it is extremely difficult to design a Fund-supported program, which is built on a central baseline, and assess that it would lead to resolving the country's BoP problem and restoring debt sustainability and medium-term external viability.

20. Approval of a UCT arrangement under such circumstances would require a judgment that a program can be designed and implemented to solve the member's BoP problem and restore medium-term external viability. Thus, in some way the problem of "exceptionally high uncertainty" needs to be made tractable in program design. Staff would propose to do this by moving away from crafting a program around a central scenario—the Fund's standard approach—in favor of establishing that a program can work in a range of scenarios. In this way, confidence that the agreed policies and reforms can restore medium term viability can be established, notwithstanding the inherent uncertainty about any one scenario. More specifically, two sufficiently separated scenarios could be set out (thus also giving confidence about scenarios in between):

- **A baseline scenario built on an assumption about how the exogenous factors driving the exceptionally high uncertainty evolve** (e.g., a large-scale war winding down). This scenario would need to resolve the BoP problem and restore medium term external viability. This requires, among other things, a detailed DSA that indicates that debt sustainability can be restored over the medium term, together with adequate financing assurances to ensure that the program is fully financed and that there are adequate safeguards including on the member's capacity to repay the Fund.

- **A downside scenario capturing the significant risk that the exogenous factors driving the exceptionally high uncertainty persist.** This should aim to push assumptions to the limit where a Fund-supported program would still be able to meet its objectives (thus maximizing confidence that there is a space for a program to work). This would require a combination of contingent adjustment policies and external financing that would still address the BoP problem and restore medium-term external viability while providing appropriate safeguards in that scenario, including with respect to capacity to repay the Fund (and taking into account any grants and/or highly concessional financing committed by donors as a backstop).

21. Designing a UCT program based on these two scenarios would be very challenging and would require:

- Program assumptions on baseline and downside scenarios that are consistent with the country context at the time of arrangement approval and at subsequent reviews. Since the shock would typically originate in factors beyond the control of economic policies, such assumptions would lie beyond the competency of Fund management and staff. Accordingly, management and staff would be expected to draw on the expertise of other organizations to help guide judgment.

- The member is sufficiently committed to and has the capacity to implement the program. This includes, confidence that the member would have sufficient economic policy control to implement the program from the outset, and would provide necessary data for the Fund to monitor program implementation. This could require establishing a track record (e.g., under a staff monitored program, or PMB).

- A program of sufficient length to provide the member more time to adjust, with some room to accommodate a wider range of assumptions and greater scope to adjust the program per the downside scenario contingency plan if the situation persists longer than envisaged.

- Sufficient donor support, on appropriately concessional financial terms, committed to cover the program period and beyond. This includes a clear commitment of contingent donor support on appropriately concessional terms to complement stronger policy adjustments needed under the downside scenario (to strengthen the case at the arrangement approval that the program can deliver notwithstanding exceptionally high uncertainty).

- Financing assurances from donors and creditors regarding debt sustainability (on both the baseline and downside scenario).

- Adequate safeguards for repayment to the Fund, including in tail risk scenarios beyond the downside scenario.

22. A judgment about whether such a UCT program design would be feasible and credible, consistent with legal and policy requirements for Fund lending including adequate safeguards, would need to be made before proceeding. Management and staff would need to do this before circulating a UFR request to the Board and the Board at the time of approval of the arrangement as well as at subsequent reviews. To the extent the exceptionally high uncertainty dissipates, the situation would go back to a standard Fund approach built just around the baseline. If it remains, then program reviews would need to continue to preserve the structure of two feasible scenarios and be able to assess that the two scenarios remained sufficiently separated to give confidence. If the exceptionally high uncertainty were to escalate or continue for too long, then the level of confidence could become sufficiently low that management and staff would not be able to clearly and credibly establish a program design—including a feasible downside scenario—that would resolve the member's BoP problem. Further Fund lending under the arrangement would become infeasible.

CAN SUCH A PROGRAM DESIGN BE ACCOMMODATED UNDER FUND DEBT POLICIES?

23. Pursuing such a design for a UCT quality program under exceptionally high uncertainty would create two key tensions for existing Fund policies. First, the two scenarios together—baseline and downside—may help establish a credible set of policy adjustments that could contribute to program success. However, the Fund's debt sustainability requirements are equally critical to the ability of the program to resolve the member's BoP problem and restore medium-term external viability, and these requirements are set up to work from a baseline with sufficient probability, not two scenarios. Creditors could be asked to give relief in line with the downside scenario, but might be reluctant to provide such significant relief, viewing the downside scenario as being overly pessimistic. Second, remaining tail risk scenarios beyond the downside would present a problem in establishing adequate safeguards for Fund lending, as required under the Articles. Normally the strength of the Fund supported program provides such safeguards, but under the tail risk scenarios the member could lack capacity to repay the Fund (despite the relevant UCT program being designed ex ante to resolve the member's balance of payments problem and achieve medium-term external viability).

24. To resolve these tensions, policy changes would be needed, and these would represent a very significant amendment to the Fund's standard approach. A first policy change would provide for a modified way for a set of official bilateral creditors to deliver credible upfront assurances, i.e., covering their commitments to help restore debt sustainability. A second change would establish the need for a set of official bilateral creditors and donors (as necessary) to provide to the Fund a credible assurance about the member's capacity to repay in a UCT lending context. This would extend the present use of this approach from emergency financing to a UCT context, and guide Fund policy going forward in a UCT lending context under exceptionally high uncertainty.

25. The first targeted policy change would allow, in situations involving exceptionally high uncertainty, official bilateral creditors to deliver credible assurances upfront, but with a second-stage contingent element. Thus, they would provide:

i. An upfront "credible and specific" assurance covering what is needed in the baseline scenario to restore debt sustainability. This could be cast as a flow then stock treatment (per HIPC), although the scale of the second stage debt relief commitment would need to be clear to help condition expectations of the other creditors expected to restructure in the interim (e.g., the private sector, which would not be eligible for such an approach under Fund policies).

ii. An upfront assurance to provide the necessary financial support to restore debt sustainability in a second stage once the exceptionally high uncertainty abates within program (or based on a best estimate at the last program review, whichever comes first). The program's downside scenario would provide an upfront estimate of the possible scale of the needed financial support, in the event outcomes are more adverse. In line with standard program practice, scenarios would be updated at each program review and financing commitments updated if necessary, providing full transparency to creditors and donors and control over their commitment.

Together, these would also help establish the ability of the program to resolve the BoP problem by restoring debt sustainability. The assurances would be given by a recognized creditor forum, and/or directly (in line with the Fund's standards for such assurances).[13]

[13]Note that in some circumstances restoring sustainability might go beyond debt relief to a need for financing on highly concessional terms. The mix of relief and new financing is within the discretion of the creditors/donors, provided it adds up to provide the required financing. For new highly concessional financing, the requirements for standard financing assurances would apply.

26. The second policy change would extend the existing use of a capacity-to-repay assurance from official creditors/donors for safeguards purposes in an emergency financing context to a UCT context. The use of such an assurance would be required in situations of exceptionally high uncertainty, since this would be critical for the assessment that the UCT program provides adequate safeguards for the Fund's lending (given tail risk scenarios where the member may not be able to generate the resources to repay any creditor). The assurance:

- Should be extended by a significant group of creditors/donors. Considering the long potential timeframe during which an assurance could be outstanding, having a significant group of creditors/donors would help ensure that adverse changes in individual members' external position would not undermine the credibility of the assurance, and give confidence that it could be amended as needed during program reviews, if necessary. A group also ensures that a sufficient shareholding in the Fund is represented (and the group would thus bear a meaningful collective cost of not standing behind the assurance). Individual members of the group should be participants in the Fund's FTP and have a collective history of contributions to multilateral debt relief initiatives commensurate with the scale of their collective assurance. The joint nature of the assurance would leave space for the group to manage different domestic processes. Normally, a suitable statement from the Executive Directors representing the relevant official bilateral creditors/donors, on behalf of their country authorities would suffice to provide the assurance. The statement would need to be in the public domain.

- It would confirm the creditors'/donors' recognition of the Fund's de facto preferred creditor status (PCS) and complement the Fund's risk management framework with the aim to prevent any overdue financial obligations to the Fund from the borrowing member and to thus establish "ex ante" adequate lending safeguards. ,Management, staff and the Board would need to assess at program outset and each review that scenarios which would give rise to any overdue financial obligations are very unlikely, and adequate safeguards for Fund lending are in place as required under the Articles.[14] This type of assurance would cease to be effective upon approval of a new arrangement for the member (unless specifically renewed, for example, because of a continuation of the exceptionally high uncertainty).

27. As noted, no policy change is proposed with respect to the Fund's approach to assurances about private sector restructuring in cases of exceptionally high uncertainty. Consistent with current policy, if a contribution is required by the private sector (which will almost surely be the case), lending would only be feasible if the Fund also has assurances, if relevant, that private sector debt will also be restructured in a manner sufficient to restore debt sustainability and ensure the program is fully financed. This, in the absence of arrears, requires that the Fund judge that a "credible process" for debt restructuring is underway and such debt restructuring will likely deliver an outcome in line with program parameters. Such a judgment would not be possible if the type of extended two-step arrangement proposed for official bilateral creditors were to be allowed

[14] As discussed in Section VI, there could be instances where a member could not exercise its rights and obligations in the Fund (e.g., where there is no government recognized for the member by the international community), and in such an extreme case the assurance would cease to be effective.

for private sector restructuring processes (especially given likely changes in private creditor composition and cooperativeness). In an arrears situation, the Fund's lending into arrears policy would apply.[15] The strong signal from official creditors about their commitment would be expected to guide the calibration of the authorities' request to private creditors and mitigate potential problems over what would constitute comparability of treatment.

28. A Board determination that exceptionally high uncertainty existed in a specific case would not be a guarantee that the Fund could provide UCT financing. Management and staff would engage to this end, but program design understandings would need to be reached (see paragraphs 19-21) and the specific conditions associated with the assurances would also need to be met (see paragraphs 25-26). If the Fund could not go forward because UCT lending conditions could not be met, the Fund would still be in a position to convene donors towards direct assistance and might still be in a position to provide emergency financing, to the extent the conditions are met and adequate safeguards could be secured.

ENTERPRISE RISK ASSESSMENT

29. Proceeding with the proposed targeted reforms to facilitate engagement through UCT-quality programs in such situations will raise sizable enterprise risks to the Fund:

- **Potential high-level consequences include the following:**
  - **The scope and speed of the envisaged policy changes may not allow for sufficient discussion and reflection of its consequences. There are two dimensions to this:**
    - **Financial risks.** If the policy turns out to be not adequately ring-fenced, then it could be applied more frequently than expected, also leading to unforeseen demand for Fund resources, also with attendant increase in financial risks. This risk could be mitigated through appropriate ringfencing, while updated lending demand forecasts and actions underway to boost the Fund's lending resources would also help.
    - **Operational risks.** These would include integration of the new policy within the Fund's current processes, and human capital risks from staff's lack of expertise in the new policy (e.g. designing downside scenarios and securing the two-stage financing assurances necessary). These would need to be mitigated by appropriate guidance to staff.
  - **Setting a precedent for UCT lending with different modalities and higher risks.** The program supported by the Fund's lending (while being designed to resolve the country's BoP problem and restore medium-term external viability) would not in itself provide sufficient assurances regarding adequate lending safeguards and capacity to repay the Fund. The proposed credible assurance from official creditors would instead address the safeguards

[15] See the Arrears Paper.

concerns with respect to capacity to repay the Fund in the tail risk scenarios, creating a precedent for other UCT programs. This in turn could raise a broader question regarding potential implications for the Fund's catalytic role and PCS which have both been linked to the design of such a UCT program. Overall, this implies higher lending risks. This is partly mitigated by the proposed procedural safeguard that helps to ensure that all criteria for UCT lending in exceptionally high uncertainty would be met.

- **Uniformity of treatment.** The Fund will incur a reputational risk from the perception that the policy justification and ring-fencing is driven by the desire to support a particular member. Of course, this would be partly mitigated by the Fund's past track record of emergency financing in situations with features of exceptionally high uncertainty, involving applications across different regions and with different donor groups. The clarity about the framework also can help ensure consistent application going forward.

- **Fund decision making.** To the extent that discussion of the policy change surfaces wide divergences amongst Fund members on the merits of proceeding, this could weaken the Fund's tradition of consensus-based decision making which has been an important factor in the Fund's ability to respond to evolving needs of its members. This risk, which may be judged to be of very low probability, could be mitigated by the ability of the Fund to ensure adequate ring-fencing and uniformity of treatment of the proposed new policy, as described above.

- **Second, considerable enterprise risks could also arise in actual applications of the policy, and these could also interact (highlighting the Board's role in assessing this for any individual case):**

  - **Contributing to geo-economic fragmentation.** If the policy is applied in a conflict situation, and the Fund is seen as aligning with one side this would contribute to the risk of geo-economic fragmentation via a dispersed and less cooperative global financial safety net, as members with dissenting political views could be more attracted to alternative financing institutions. This may also place the Fund in a position of being asked by both sides for support and undermining the Fund's duty of neutrality in disputes between members, which means that it cannot take sides in disputes or conflicts.

  - **Program design misspecification.** Exceptionally high uncertainty could make it difficult to design program scenarios, as the factors driving exceptional uncertainty would be likely to reduce the quality of information available and raise questions about the capacity of the member to undertake policies. This would tend to manifest itself in a faster migration towards the initial calibration of the downside scenario, giving rise to larger financing gaps exceeding the size of creditor/donor commitments, and in turn leading to political fatigue and difficulties in securing the then required supplementary commitments at reviews, thus creating an elevated risk of program failure.

- **Program implementation affected by higher moral hazard.** The extent of the required creditor/donor assurances may also contribute to moral hazard by reducing the authorities' incentives for full implementation of the Fund-supported program, impacting implementation and amplifying credit risks. The standard design of a Fund program, involving reviews and phasing, can help mitigate this risk.

- **Creditor/donor failure to act on assurances.** The debt sustainability assurances involve a potentially evolving commitment and backloaded delivery, while the capacity to repay assurance for safeguards purposes is not a legally binding guarantee. Failure of creditors/donors to act would imply higher financial risks to the Fund and capacity to repay concerns (with possible implications for burden sharing). This is partly mitigated by the need for a group of donors/creditors to provide the assurances, and by the need for each of them to have sufficient financial strength and track record of previous contributions to support multilateral debt relief initiatives.

- **Extreme scenarios beyond the capacity to repay assurances.** There could be instances where the borrowing member could not exercise its rights and obligations in the Fund (e.g., where there is no government recognized for the member by the international community) and in such an extreme case the assurance would cease to be effective. This would involve a critical impact on the Fund. After 6 months, when overdue financial obligations would become protracted, the Fund's burden sharing mechanism would take effect, and the Fund's creditor and debtor members would need to contribute financing to cover the amount of unpaid basic charges and surcharges. At some point, concerns about a member's ultimate repayment could trigger recording a provision for expected credit losses under International Financial Reporting Standards, which would reduce the Fund's income and (accumulation of) precautionary balances. Management, staff, and the Board would need to assess at the program outset and at each review that the scenarios which could give rise to such impacts are very unlikely, and adequate safeguards for Fund lending are in place as required under the Articles of Agreement. This provides a risk mitigant for all amounts not yet disbursed. If it is yet assessed that adequate safeguards are not in place at the time of any new purchase under the arrangement, then other means of securing those safeguards for Fund financing would need to be considered in order for the Fund's financing to continue.

30. Not changing the policy also has significant drawbacks:

- **Reputational risks.** Even though such situations are expected to remain rare, when they do arise the Fund could face a situation involving a member with strong policies that is facing an exogenous shock. If the Fund is unable to support such a member in need, it could face a perception that it is institutionally irrelevant or ineffective. Communication could help mitigate this, but a perception that the Fund would be failing to adapt to the changing needs of its membership would make it more difficult to address.

- **Spillovers.** The Fund's wider membership could face spillovers due to inaction. The member in question could be deeply integrated into financial markets or have concentrated enough positions in global production or value chains that not assisting it would have significant negative externalities.
- **Financial risks.** The Fund could also face financial risks by not going ahead, since the member experiencing exceptionally high uncertainty would not have access to a UCT program to resolve its BoP problem and could accumulate overdue financial obligations to the Fund (where it may have been able to remain current with the support of a UCT program that would help address its BoP problem and restore medium term external viability).

31. Overall, the proposed policy changes to facilitate UCT engagement in situations of exceptionally high uncertainty involve significant risks to the Fund that need to be carefully weighed against the risks of remaining in the Fund's present approach. The proposed shift in modalities for UCT lending raises operational and broader issues, and in any particular application would involve many challenges. At the same time, not making such changes may lead to the Fund being perceived as ineffective in delivering its mandate. The Fund in the past has been able to adjust its toolkit and policies successfully to meet evolving needs of the membership, notwithstanding perceived risks. As noted above, there are meaningful mitigating factors in any specific application of the proposed policy changes, which would limit such UCT programs to cases where the authorities have capacity and sufficient commitment to implement the program, and the need for strong financing assurances from donors and creditors. The Fund's robust internal review process and application of other relevant Fund policies (e.g. on conditionality) would serve to guard the process to ensure that all criteria for UCT lending are met in each specific application, The Board may overall judge that the benefit of having the option of supporting members facing exceptional uncertainty outweighs the additional risk of the proposed policy change.

ISSUES FOR DISCUSSION

Do Directors agree with the characterization of situations involving exceptionally high uncertainty?

Do Directors agree that in such circumstances where UCT program engagement is considered, a procedural safeguard as outlined in paragraph 18, should apply?

Do Directors agree that a modified program design involving two scenarios (instead of one central scenario) can give the Fund sufficient confidence that the member's BoP problem can be resolved and medium-term external viability will be restored despite such exceptionally high uncertainty?

Do Directors agree that the Fund should consider a change to the Fund's financing assurances policy and extension of a capacity-to-repay assurance to a UCT context, as described in paragraphs 23-26?

Do Directors agree about that the capacity-to-repay assurance should complement the Fund's ex-ante risk management framework (to ensure adequate safeguards and guard against overdue financial obligations to the Fund), taking note of the technical understandings of this laid out in the paper?