

Countercyclical Financial Instruments

Building fiscal resilience to exogenous shocks



The Commonwealth

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Acronyms and Abbreviations

AFD	Agence Française de Développement
AfDB	African Development Bank
APRM	Agricultural Price Risk Management
CCPs	Countercyclical Provisions
CCRIF SPC	Caribbean Catastrophic Risk Insurance Facility
CDMA	Commonwealth Disaster Management Agency
CRA	Credit-Rating Agency
EM-DAT	International Disasters Database
FLL	Flexible Liquidity Line
GDP	Gross Domestic Product
HIPC	Highly Indebted Poor Country (Initiative)
IBRD	International Bank of Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation
IFI	international Financial Institution
IMF	International Monetary Fund
IPCC	International Panel on Climate Change
LICs	Low-Income Countries
MDB	Multilateral Development Bank
MDRI	Multilateral Debt Relief Initiative
PLL	Precautionary Liquidity Line
PRVR	Prêt à Remboursement Variable et Reechelonable
PTCC	Prêt Très Concessionnel Contracyclique
RCF	Rapid Credit Facility
RFI	Rapid Financing Instrument
RIO	Repayment Interruption Option
SCF	Standby Credit Facility
SDGs	Sustainable Development Goals
SDRs	Special Drawing Rights

Executive Summary

The rising incidence of exogenous shocks has been one of the least appreciated, but most important, trends in modern international development. Natural disasters and terms of trade shocks have imposed significant costs for the Commonwealth's developing member states, which are particularly vulnerable to such events as a result of their geographic positioning, inherent structural challenges and particular form of integration into the global economy.

The bulk of shock financing is currently provided ex-post, i.e. in response to or following a shock, and such assistance continues to play a vital role as part of efforts to moderate the impacts of sudden external shocks. However, the current ex-post financing portfolio has been unequally applied and is insufficient to address the scale of the challenge. Moreover, ex-post assistance has often proved to be slow to disburse and take effect, and in certain cases has augmented the debt stock of countries with already challenging debt dynamics.

An enhanced approach to disaster risk management is now imperative to build the capacity of countries to both anticipate and effectively manage the growing frequency, severity and costs of adverse external events. Re-balancing risk management strategies – towards the greater utilisation of complementary ex-ante shock-financing mechanisms – could help to mitigate the growth and welfare losses associated with exogenous shocks.

Ex-ante financial instruments incorporate contingency measures to anticipate needs in the event of a shock, and offer complementary benefits to ex-post assistance programs. These include, *inter alia*, preserving fiscal space through the immediate provision of liquidity following a shock, and enhancing the predictability of public finances. Furthermore, by mitigating the impacts of adverse external events, ex-ante mechanisms have the potential to reduce the scale of financing required when post-shock assistance proves to be necessary. Ex-ante approaches can also help to increase market confidence in existing International Financial Institutions' (IFI) assistance programs, by strengthening the probability that the structural reforms that

countries commit to when seeking to access ex-post assistance will be successfully implemented when adverse events occur.

While a range of ex-ante financial instruments are available – such as international buffer stocks; contingent financing arrangements; hedging products; insurance facilities; credit enhancement tools; and index or risk-linked loans and securities – a number of supply-side challenges have restricted creditors from offering these instruments on a large scale. These include cash-flow risk and liquidity concerns; first mover considerations and co-ordination failures; challenges related to shock measurement and verification; short political time horizons; and the limitations of country legal and regulatory frameworks in supporting the use of risk management tools.

In light of the urgency to address the rising costs of exogenous shocks, and the continued interest from the Commonwealth membership in preventative financial instruments, the Commonwealth Secretariat is reassessing this issue, with a particular focus on the potential for creditors to grow the share of ex-ante mechanisms, as complementary risk management tools in the global shock-financing architecture.

This paper explores the potential for implementing ex-ante *countercyclical provisions (CCPs)*. CCPs are loans or debt securities that feature an ex-ante covenant, in which countries' debt service obligations are temporarily permitted to fall in response to an external shock.

CCPs can be a particularly valuable addition to countries' risk management strategies for three main reasons: 1) helping to safeguard fiscal space and debt sustainability through the provision of immediate liquidity following a shock; 2) mitigating the likelihood of debt default through a pre-determined standstill on repayments; and 3) preventing the need for debt restructuring operations, or minimising the costs of these processes if they prove to be unavoidable.

Although the operative examples of CCPs are currently limited, both in terms of their scope and their flexibilities, the introduction of CCPs by the Government of Grenada and its creditors in the form of hurricane clauses and by the

Agence Française de Développement, through its countercyclical loan portfolio, has helped to lay the groundwork for other development finance providers and sovereign borrowers to implement CCPs and harness their benefits.

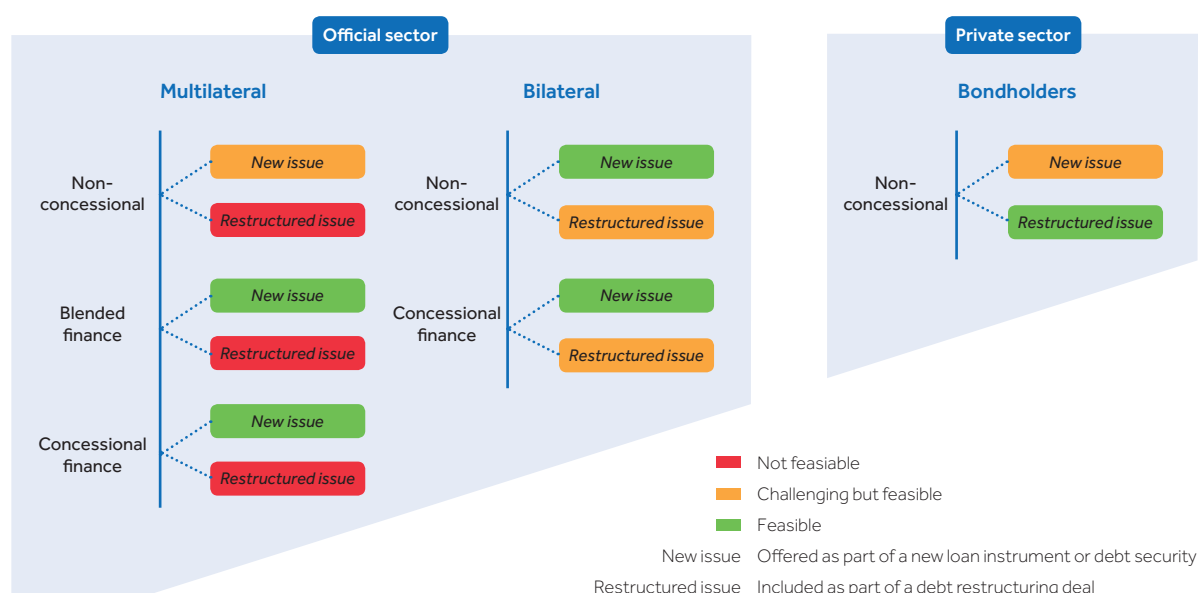
Recognising the hurdles that must be overcome with regard to the broader implementation of CCPs, this paper has undertaken a preliminary analysis of the potential for creditors to incorporate CCPs within their portfolios. The analysis undertaken suggests that the feasibility for advancing CCPs varies across the categories of creditors considered in this study (multilateral development banks, bilateral development agencies and private sector bondholders); according to the financing modality (concessional or non-concessional) in question; and whether CCPs are incorporated into a new loan instrument / debt security issue or as part of a debt restructuring agreement.

Opportunities for implementing CCPs: creditor perspectives

The opportunities for scaling up CCPs are greatest in the case of restructured bonds financed by private investors, and loans provided

by both bilateral development agencies and the concessional and blended-finance windows of multilateral development banks. Bilateral and multilateral creditors will be unlikely to incorporate CCPs as part of a restructured loan, due to often-contested and lengthy processes for bilateral debt restructuring negotiations and the un conducive political climate for further large-scale multilateral debt restructuring. The reverse is true for private-sector creditors, where restructured CCP issues appear to be a more likely proposition, given the complexity in pricing new CCPs accurately and competitively.

More work will be required to ascertain the full range of mechanisms that may be available, or that must be established, for creditors to advance CCP implementation. Going forward, successful market development will necessitate efforts to identify the configuration of an 'ideal' or 'model' CCP arrangement and to establish the expected cost and risk premium of a standardised CCP contract. Lessons should be sought from the market development experience of other index or risk-linked loans and securities, such as GDP-linked bonds, where similar efforts are currently in motion.



1. Introduction

A growing body of evidence has shown that external shocks have significant negative impacts on growth, investment and poverty in developing countries. As such, these events pose a material threat to the attainment of the sustainable development goals (SDGs), and have precipitated calls for countries' risk management strategies to be consolidated.

In particular, increasing economic and environmental uncertainty, together with concerns relating to the adequacy of the ex-post shock financing architecture, has informed the need for a re-balancing of countries' risk management strategies – towards the greater utilisation of complementary ex-ante shock-financing mechanisms.

These mechanisms are not intended to be substitutes, but rather complementary tools in the global shock-financing architecture that can help to facilitate prompt, efficient and responsible lending to those jurisdictions that are most exposed and vulnerable to exogenous shocks. By mitigating the impact of shocks, ex-ante mechanisms also have the

potential to play a valuable role in reducing the scale of financing required when post-shock assistance proves to be necessary – i.e. in the event that a shock turns out to be protracted rather than transitory.

This paper focuses on the potential for growing the market share of countercyclical provisions (CCPs) - loans or debt securities that feature an ex-ante covenant, in which countries' debt service obligations are temporarily permitted to fall in response to an external shock.

The paper begins with a discussion of the costs associated with increasing economic and environmental uncertainty for Commonwealth member states. Next, an overview of the current shock-financing landscape, and its core limitations, is provided to articulate the value of CCPs with ex-ante flexibility. The benefits of CCPs and key examples are subsequently documented. Following which, the scope for scale-up by official and private sector creditors to tender such flexibility within their portfolios is examined.

2. Uncertainty on the Rise – An Impetus for Change

2.1 Natural disasters

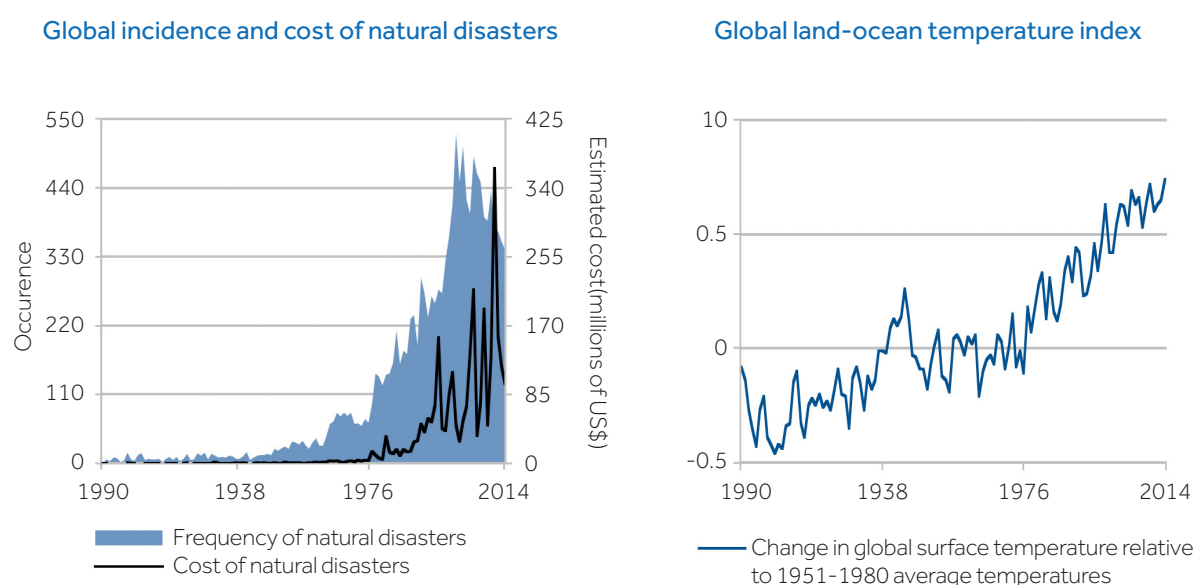
The rising incidence of exogenous shocks has been one of the least appreciated, but most important, trends in modern international development. According to the International Disasters Database (EM-DAT), natural disasters have risen dramatically over the past century, with such events now more than 50 times as frequent today than they were in the 1900s.¹

Global warming is recognised to have played a significant role in this increase, with approximately half of the natural catastrophes that took place in 2014 linked to climate change.² In addition, environmental modelling from the International Panel on Climate Change (IPCC) has established that a failure to anchor greenhouse gas emissions in the global commitments set out in the Paris Agreement³ will augment the frequency and severity of these shocks going forward.⁴ With insufficient investment into climate change adaptation and mitigation now recognised to be a core global risk,⁵ the likelihood of such a future is

increasing. Figure 2.1 shows the global incidence and cost of natural disasters since the 1900s, and the global land-ocean temperature over the same time period.

- 1 The developing world has been most impacted. IMF staff calculations have established that the average number of years between the reoccurrences of large natural disasters in developing countries has steadily declined from the late 1970s onwards. See, for example: IMF (2003), Fund Assistance for Countries Facing Exogenous Shocks
- 2 Herring, SC, MP Hoerling, JP Kossin, TC Peterson and PA Stott (Eds.) (2015), 'Explaining Extreme Events of 2014 from a Climate Perspective', Bull. Amer. Meteor. Soc., 96(12), S1–S172.
- 3 United Nations (2015), Adoption of the Paris Agreement, FCCC/CP/2015/L.9/Rev.1, available at: <https://unfccc.int/resource/docs/2015/cop21/eng/l09r01.pdf> (accessed 5 September 2016).
- 4 IPCC (no date), Intergovernmental Panel on Climate Change, Working Group II: Impacts, Adaptation and Vulnerability, available at: <http://www.ipcc.ch/ipccreports/tar/wg2/index.php?idp=354> (accessed: 5 September 2016).
- 5 World Economic Forum (2016), The Global Risks Report 2016 (11th Edition), available at: http://www3.weforum.org/docs/GRR/WEF_GRR16.pdf (accessed 5 September 2016).

Figure 2.1 Global frequency and cost of natural disasters, and global land-ocean temperature index.



Sources: The International Disasters Database (EM-DAT); and NASA's Goddard Institute for Space Studies (GISS) Global Land-Ocean Temperature Index (LOTI).

Box 2.1 The impact of Hurricane Ivan on the Grenadian economy

- In 2004, Hurricane Ivan inflicted unprecedented damage on Grenada, killing 39 people and damaging more than three quarters of the island's housing stock. The agricultural sector and other productive economic sectors were severely affected.
- Grenada's fiscal position deteriorated from a surplus of US\$17m to a deficit of US\$54m (or 4.5 per cent of GDP) reflecting lower taxation revenues.
- In Ivan's wake, the estimated damage sustained amounted to more than 200 per cent of GDP.
- With deteriorated finances, recovery efforts were funded largely by debt. The 2004 debt-to-GDP ratio grew to 95 per cent, more than 16 percentage points higher than the ratio in 2003.
- In 2005, the authorities sought a comprehensive and collaborative restructuring of the country's public debt from both its official and private creditors. This was followed by a second round of comprehensive debt restructuring in 2015.

Weather-related disasters have already levied considerable growth and rehabilitation costs for the global economy. Over the past ten years alone (2006–15), direct damages from natural catastrophes averaged US\$180 billion per annum, and almost three-quarters of these losses were uninsured.⁶

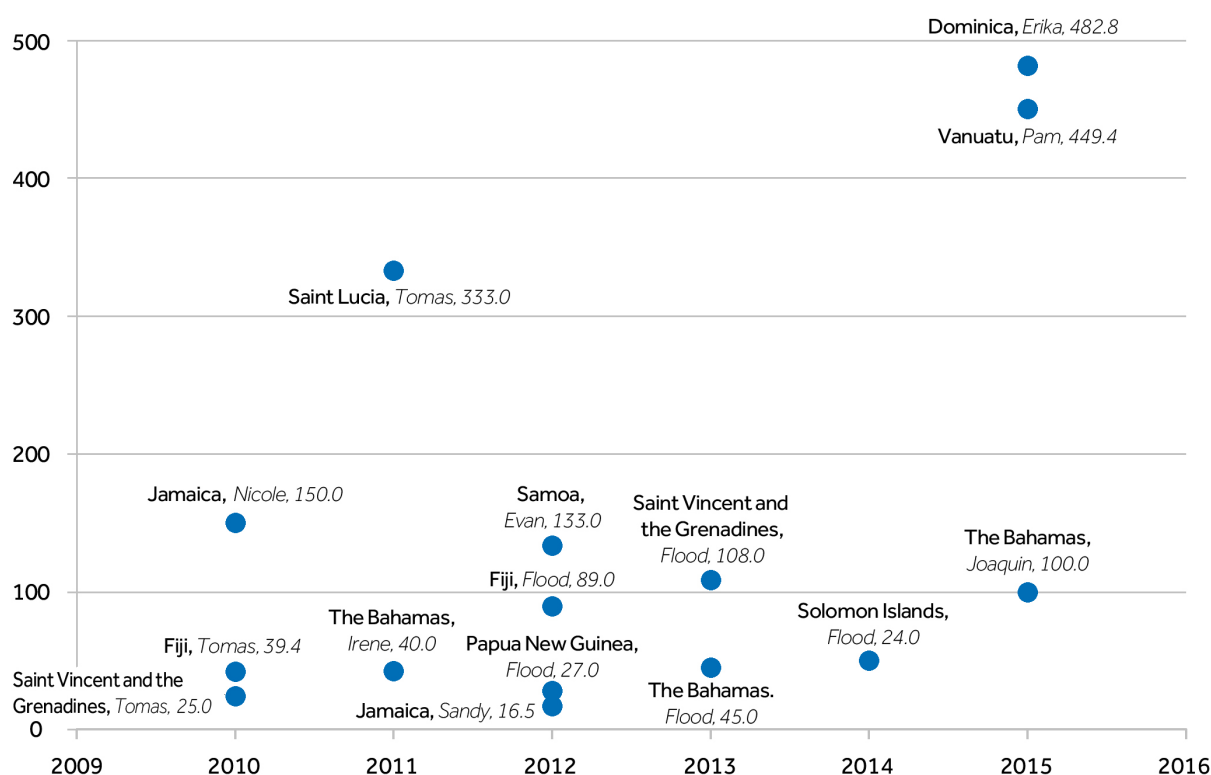
For the Commonwealth's developing member states, such as Vanuatu and Grenada, these events have imposed a disproportionate burden. The total economic cost (aggregate sectoral damages

and losses) of Cyclone Pam, for example, which devastated Vanuatu in 2015, was estimated to be US\$449.4 million, or roughly two-thirds of the country's total economic output.⁷ In Grenada, damages in the wake of Hurricane Ivan, in 2004, amounted to more than 200 per cent of gross domestic product (GDP). Before Ivan, Grenada

6 Munich Re (2016), Natural catastrophes 2015.

7 ReliefWeb (2015), Post-disaster needs assessment tropical Cyclone Pam, March 2015.

Figure 2.2 Cost of natural disasters (damage in millions of USD)



had not been hit by a hurricane since 1955.⁸ Yet the sustained damage to Grenada's physical infrastructure and the deterioration of its macroeconomic fundamentals illustrated that even a single catastrophic natural event has the potential to significantly derail a country's development progress, and that there is an increasing need for countries to prepare for such eventualities appropriately. Box 2.1 outlines the impact of Hurricane Ivan on Grenada's macroeconomic performance, while Figure 2.2 shows the cost of natural disasters across the Commonwealth over the last eight years.

2.2 Economic shocks

For many developing Commonwealth member states, the impacts of economic shocks⁹ have been exacerbated by a number of structural challenges, including low levels of economic diversification and an acute dependence on commodity markets as a driver for growth.¹⁰ Commodity exports are estimated to represent between 10 and 70 per cent of GDP in more than 20 of the Commonwealth's developing member countries.¹¹ As a result, a significant share of Commonwealth members are exposed, albeit to varying degrees, to the detrimental macroeconomic impacts of commodity price volatility,¹² which has significantly increased in recent years.¹³ Negative terms of trade shocks, linked to commodity price variability, have been found to explain a considerable share of debt and fiscal challenges in commodity-dependent countries,¹⁴ and have pressured macroeconomic fundamentals in several Commonwealth member states. Zambia provides a pertinent example. Copper accounts for approximately 80 per cent of the total value of Zambia's exports, and the country has consequently become heavily dependent on this market as a driver for growth. Increasing copper price volatility, both in the run up to and following the global financial crisis, greatly impacted Zambia's fiscal revenues, which are projected to decline by 7 percentage points from their pre-crisis level to 17 per cent of GDP in 2016.¹⁵

2.3 Fiscal space and debt sustainability in times of economic distress

When faced with an adverse external shock, the Commonwealth's developing member states are burdened with a number of competing demands

on public-sector expenditure: rapidly delivering post-shock capital to support short-term economic recovery; augmenting social security payments to accommodate increased welfare demand; investing to rebuild critical economic and physical infrastructure; and satisfying debt service obligations. Grenada's economic recovery process following Hurricane Ivan, for example, which necessitated large-scale stimulus efforts from Grenadian government agencies,¹⁶ encapsulated this challenge, as stimulus requirements were somewhat at odds with the long-standing need for addressing the island's growing fiscal imbalances and public debt burden. As noted by the International Monetary Fund (IMF) in its 2006 report on Grenada's *Request for a Three-Year Arrangement Under the Poverty Reduction and*

8 IMF (2006), *Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility*

9 These include both short-run and long-run shocks, such as commodity price volatility, rapid net capital outflows, deteriorating terms of trade the compression of aid flows and the dismantling of preferential trade agreements.

10 Commonwealth small states are particularly vulnerable to exogenous shocks, due to their geographic positioning, inherent structural challenges and particular form of integration into the global economy. Narrow resource bases and limited domestic markets, for instance, have restricted diversification in small states' export and production mixes, leaving these nations highly dependent on international trade and extremely vulnerable to the consequences of commodity price volatility, capital flight and global economic downturns. 'Smallness', moreover, has not only restricted opportunities for economies of scale – it has also served to magnify the country wide-impacts from frequently occurring natural disasters.

11 UNCTAD (2015), 'State of Commodity Dependence 2014', UN Conference on Trade and Development

12 These include: lower aggregate credit growth; inducing policy changes that are detrimental to future growth performance; the deterioration of the current account balance and the fiscal position; uncertainty over future price levels; and underinvestment into physical assets to support growth (see: Caliri, A [2012], *Macroeconomic impacts of commodity price volatility: G20 report* [July 2012].

13 Dwyer, A, G Gardner and T Williams (2011), *Global Commodity Markets – Price Volatility and Financialisation*

14 Swaray, R (2005), 'Primary Commodity Dependence and Debt Problems in Less Developed Countries', *Applied Econometrics and International Development*, Vol. 5 No. 4, 131–142.

15 Based on World Economic Outlook Database (April 2016). 'Pre-crisis' refers to the time period 2001–06. Zambia's fiscal revenues over this period averaged out to 24 per cent of GDP.

16 World Bank (2005), *Grenada: A Nation Rebuilding – An assessment of reconstruction and economic recovery one year after Hurricane Ivan*

Growth Facility, '[Grenada's] large-scale physical reconstruction effort currently underway needs to be accompanied by fiscal consolidation to reduce public indebtedness'.¹⁷

For highly indebted countries,¹⁸ debt servicing has often acted as a brake on all other processes, and served to delay economic recovery. Yet increasingly, the prioritisation of debt repayments in times of severe crisis has been politically

challenging to validate.¹⁹ Exogenous shocks have pressured sovereigns to consider defaulting on financing obligations and engaging in debt restructuring processes. This course of action entails significant political and economic costs, including reputational damage and reduced creditworthiness in the medium term,²⁰ as well as a range of macroeconomic crises that,²¹ on average, contribute to output losses of at least 5 per cent per annum, typically over a ten-year timeframe.²²

17 IMF (2006), Request for a Three-Year Arrangement, op. cit.

18 According to the World Economic Outlook database, in 2015, 23 Commonwealth countries were in excess of the IMF's guideline prudential debt-to-GDP threshold of 60 per cent. The majority of these countries are located in the Caribbean. In this region, gross government debt as a share of GDP reached 84 per cent on average in the same year.

19 One prominent example of this was the G20's recent call on the IMF to provide debt relief (both in terms of 'haircuts' and enhanced repayment flexibility) for countries severely impacted by the West African Ebola virus epidemic. See: IMF (2015), IMF response to the Ebola crisis).

20 Das, US, MG Papaioannou and C Trebesch (2012), Sovereign Debt Restructurings 1950–2010: Concepts, Literature Survey, and Stylized Facts.

21 These include: rising inflation; exchange rate crashes; currency debasements; the deterioration of banks' financial positions; and reduced trade and foreign direct investment (FDI) flows. See: Reinhart, C, and K Rogoff (2008), This Time is Different: A Panoramic View of Eight Centuries of Financial Crises, Manuscript, Harvard University and NBER.

22 De Paoli, B, G Hoggarth and V Saporta (2009), 'Output costs of sovereign crises: Some empirical estimates', Working Paper No. 362

3. The Global Shock-Financing Architecture

3.1 Response of international financial institutions (IFIs) to the global financial crisis of 2007–09

The 2007–09 financial crisis triggered the most severe decline in international growth since the 1930s,²³ and called for a substantial capital injection to stimulate the process of global economic recovery.

As mandated by the G20,²⁴ international financial institutions (IFIs) co-ordinated the global economic response through a substantial expansion of their shock-financing facilities and economic assistance programmes. Led primarily by the World Bank and the IMF, IFIs collectively increased their operations by US\$101 billion from 2008 to 2009 alone, and by almost 70 per cent from 2005–07 to 2008–10.²⁵

3.2 The shock-financing landscape

The contemporary shock-financing landscape has largely been shaped by IFIs' support following the 2007–09 financial crisis, reflecting its record scale and depth, and the protracted nature of the global economic recovery. As represented by Figure 3.1, the international shock-financing architecture can broadly be divided into two categories: 1) pre-shock and post-shock financial instruments to mitigate the impact of exogenous shocks; and 2) non-financial instruments geared towards the provision of humanitarian assistance in the aftermath of a shock.

Pre-shock, or ex-ante, financial instruments incorporate contingency measures to anticipate needs in the event of a shock. Examples of such mechanisms include international buffer stocks; contingent financing operations, such as loan arrangements approved prior to the onset of an economic shock, which can be drawn-down once a shock occurs; hedging products for managing a range of risks, such as weather or commodity derivatives (for example, the International Finance Corporation's [IFC's] Agricultural Price Risk Management [APRM] mechanism); insurance

facilities for commodity price shocks and natural disasters, such as crop insurance mechanisms, the Commonwealth Disaster Management Agency (CDMA) and the Caribbean Risk Insurance Facility (CCRIF SPC); credit enhancement tools, such as risk guarantees to crowd-in post-shock investment; and instruments indexed to either macroeconomic performance or risk, such as GDP-linked bonds, catastrophe bonds, sovereign CoCo bonds and CCPs.

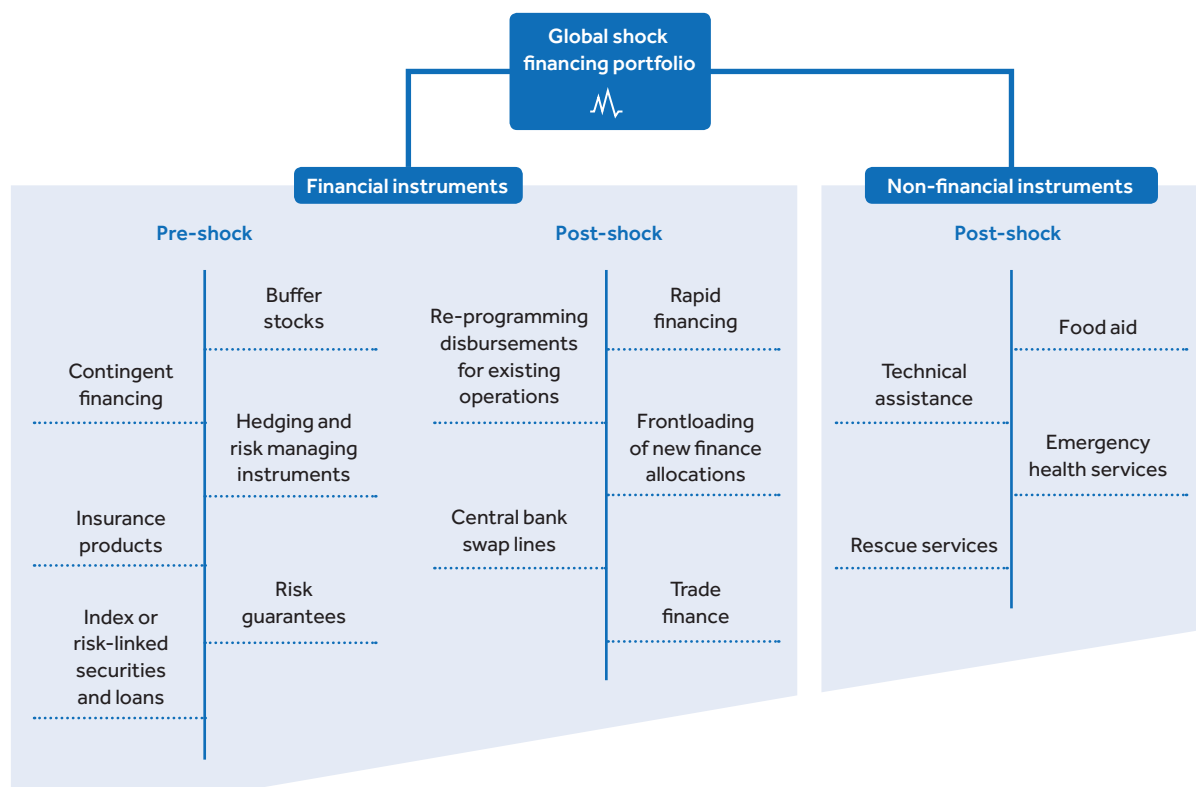
Bilateral and multilateral agencies currently provide the bulk of shock financing ex-post – i.e. following, or in response to, a shock – for both economic rehabilitation and humanitarian objectives. The IMF is the most prominent multilateral body operating in the financing for economic stability sector. Its mandate concerns balance of payments stabilisation following a shock. Other multilateral agencies largely specialise in the provision of long-term development financing. Outside of this assistance, key post-shock instruments in the global shock-financing portfolio include trade finance (for example, the IFC's guarantees for payment risk in trade transactions) and central bank swap lines, which have been used extensively since the global financial crisis as a means for central banks to obtain foreign currency to boost reserves, ease liquidity constraints, and increase on-lending to domestic banks and corporations.²⁶

23 Mohammed, N, M Zia Qureshi and CA Primo Braga (2010), *The Impact of the Financial Crisis on the Millennium Development Goals (MDGs) in the Commonwealth Countries*, Commonwealth Secretariat, London.

24 Australian Treasury (2012), 'Section 1: Responding to the global economic crisis'.

25 World Bank (2014), Crisis response, available at: <http://ieg.worldbank.org/topic/crisis-response> (accessed 5 September 2016).

26 Council on Foreign Relations (2016), Central bank currency swaps, available at: http://www.cfr.org/international-finance/central-bank-currency-swaps-since-financial-crisis/p36419/#!/?cid=otr-marketing_use-currency_swaps (accessed 5 September 2016).

Figure 3.1 The Global shock financing architecture

Source: Author's research

3.3 Comparative advantages and challenges of ex-post and ex-ante shock-financing mechanisms

3.3.1 Ex-post shock assistance

As evidenced by the efficacy of the countercyclical response from IFIs and governments to address the economic consequences of the global financial crisis,²⁷ financial stimulus packages and other post-shock mechanisms continue to play a significant role in supporting macroeconomic stability and shock recovery. Furthermore, because ex-post approaches are not liable to uncertainty regarding the actual impact of a shock, they can be better targeted to post-shock needs.

However, there are also several limitations with post-shock instruments in their current form, which have established the need for a more comprehensive approach to risk management. These include:

Timeliness of funds release: Experience with ex-post facilities has shown that they often can be slow to disburse, due to the time needed to make an assessment of damages following a shock; complex approval processes; conditionalities attached to

loan arrangements that countries must satisfy before funds can be released; and requirements for countries to outline how they plan to use assistance packages before any resources can be accessed. The most significant increase in IFI assistance in response to the global financial crash, for instance, occurred in 2009–10, two years after the onset of the crisis.²⁸

Scale and access: Although several rapid ex-post financing mechanisms are currently available, these facilities are often limited in scale, due to the significant opportunity cost of diverting funds away from development finance projects to grow the pool of resources available for supporting shock-financing initiatives. The scale of available assistance has been further limited by the fact that country quotas regulate access to emergency financing. For example, the IMF's rapid emergency support to address the impacts of natural disasters and armed conflicts is limited to 25 per cent of a member country's quota (although amounts up to 50 per

27 International Labour Organization (2011), A review of global fiscal stimulus.

28 Griffith-Jones, S, and R Gottschalk (2012), Exogenous Shocks – Dealing with the Only Certainty: Uncertainty, Commonwealth Secretariat, London.

cent have been provided in some cases).²⁹ This can represent a minimal amount in relation to the total cost of a shock. For example, the 2008–11 Kenyan drought was estimated to have caused US\$10.5 billion worth of damage to the country's agricultural sector. This would not be covered by Kenya's Special Drawing Rights (SDRs) allocation, even if Kenya could access the full extent of its SDRs.³⁰

Unsystematised assistance: Although IFIs mobilised a significant quantum of resources and were successful in developing new financial mechanisms to support post-crisis recovery efforts, many of these mechanisms were offered on an ad-hoc basis (i.e. developed and provided specifically to address immediate needs emerging from the financial crisis), and have since expired.³¹ It is questionable whether IFIs will be able to co-ordinate and develop facilities in a similar manner for future crises that are less globalised, and that are smaller in scale.

Exacerbating debt challenges: Although ex-post financing can help to expand fiscal space in the aftermath an exogenous shock, this is often achieved at the cost of increased indebtedness. Many countries remain ineligible for grant finance and are therefore reliant on loan arrangements. Even if these arrangements are concessional in nature, they still ultimately augment debt, and may not represent a practical option for countries with challenging debt dynamics.

Selective assistance: Post-disaster support has often been limited to specific projects and sectors.³² In the case of natural disasters, assistance has typically been channelled to high-profile disasters (those that have marshalled significant media attention).³³ Consequently, IFI assistance has been heavily concentrated on a selected number of countries. For example, just six countries benefitted from the IMF's shock facilities for low-income countries (LICs) from their launch in 2010 until the end of 2011: US\$88 million was committed under the Rapid Credit Facility (RCF) to four countries (Saint Lucia, Saint Vincent and the Grenadines, Kyrgyz Republic and Nepal); while US\$117 million was committed under the Standby Credit Facility (SCF) to two countries (Solomon Islands and Honduras).³⁴

3.3.2 Ex-ante shock assistance

In comparison, ex-ante financing approaches offer two unique advantages over the current ex-post shock-financing portfolio:

Predictability: Owing to their 'predetermined' nature, ex-ante mechanisms provide automatic assistance in the event of a shock, and can help to reduce uncertainty related to the selectivity and size of post-shock assistance, as countries can estimate the degree of financial assistance that they will receive in the event of a shock. This can help to enhance the predictability of public finance, and enable governments to execute budgetary planning with a greater degree of precision and certainty.

Immediate liquidity and fiscal space: Ex-ante instruments are quick to disburse, as assistance is pre-agreed, providing immediate liquidity following a shock. This preserves fiscal space during times of economic stress, and can, accordingly, enable governments to accelerate economic recovery through the prioritisation of critical reconstruction, infrastructure and social welfare investments.

These advantages can be complementary to ex-post assistance packages. For example, by mitigating the impact of adverse external events, ex-ante mechanisms have the potential to reduce the scale of financing required when post-shock assistance proves to be necessary – i.e. in the event that a shock turns out to be protracted rather than transitory. Ex-ante approaches can also help to increase market confidence in existing IFI assistance programs, by strengthening the

29 International Monetary Fund (2011), 'IMF Emergency Assistance: Supporting Recovery from Natural Disasters and Armed Conflicts', Factsheet.

30 Kenya's current SDR quota is 542.8 million, which equates to US\$759 million (using the SDR-to-US dollar exchange rate as at Wednesday, 14 September 2016).

31 For example, the African Development Bank (AfDB) created an Emergency Liquidity Facility to provide financial support to middle income countries (MICs) in response to the global financial crisis. This facility was intended to complement the AfDB's range of countercyclical lending products. However, it was short-lived and discontinued in December 2010. See: African Development Bank (2011), Financial Products – Offered by the African Development Bank.

32 Dodhia, D (2008), 'The Emerging Debt Problems of Small States', Economic Paper Series edn., Commonwealth Secretariat, London.

33 Griffith-Jones and Gottschalk (2012), Exogenous Shocks, op. cit.

34 The Guardian (2014), 'Media distortion and western bias – why do some disasters attract more cash?', available at: <https://www.theguardian.com/global-development/2014/dec/02/students-speak-media-distortion-western-bias-disasters> (accessed 5 September 2016).

probability that the structural reforms committed to by countries that access ex-post assistance will be successfully implemented and not be side-lined when adverse events occur.

While ex-ante financing mechanisms are available for mitigating the impact of natural disasters and terms-of-trade shocks, there are a number of supply and demand-side challenges that contribute to the underutilisation of these resources by developing countries. These include:

Ex-ante stigma: There has often been a stigma attached to ex-ante assistance, given the risk of such arrangements to either pre-emptively or falsely signal macroeconomic difficulties. The IMF has partially addressed this issue by offering a range of ex-ante instruments that enable countries with sound macroeconomic fundamentals ('good performers') to benefit from their support in the event of a crisis (in the form of the Precautionary Liquidity Line [PLL], Flexible Liquidity Line [FLL] and Rapid Financing Instrument [RFI]).³⁵ However, the countries that require this form of assistance the most - i.e. those that are the most exposed to the adverse effects of exogenous shocks - are the least likely to have sound macroeconomic fundamentals.

Upfront costs and uncertainty: Several contingent financing instruments for managing natural disasters and commodity price volatility are subject to high premiums and limited investor appetite for high-probability events. These include catastrophe bonds, weather derivatives and related contingent financial mechanisms.

Hedging instruments, such as swaps and collar contracts, can also create unknown and unpredictable future liabilities, leaving countries exposed to counterparty risks, while futures contracts lock in prices, limiting the potential for countries to benefit from price movements. This can be a significant disadvantage in the case of favourable external shocks, such as commodity price upturns.

In addition, a lack of technical knowledge and ability to exploit such mechanisms often limits their use by capacity-constrained developing countries.³⁶

Political economy constraints: Political economy considerations may prevent governments from fully capitalising on available ex-ante mechanisms. Short political time horizons, for instance, are likely to reduce the appeal of insurance policies where benefits are largely expected to accrue to successor governments.³⁷ The price of some hedging

products also increases significantly as coverage levels grow, increasing the opportunity costs for government usage.

For some countries, a 'Samaritan's Dilemma' could also be at play,³⁸ in which ex-ante facilities are not demanded, due to the expectation that ex-post assistance will be provided by the international community in the event of a shock. If creditors can successfully up-scale and incentivise the use of ex-ante assistance for sovereign debtors, one positive externality could thus be a reduction in the public aid burden following a shock.

In the case of self-insurance, buffer stocks have proved challenging to maintain for several countries, due to the high political opportunity cost of holding a large amount of cash reserves that could be used for other purposes.³⁹

Supply-side challenges: The provision of ex-ante financial instruments has been constrained by first mover considerations and co-ordination failures (e.g. the case of GDP-linked bonds); challenges related to shock measurement and verification;⁴⁰ and the limitations of country legal and regulatory frameworks in supporting the use of risk management tools.⁴¹

35 International Monetary Fund (2014), 'IMF Executive Board Discusses FCL, PLL, and RFI Review', Press Release, available at: <http://www.imf.org/external/np/sec/pr/2014/pr1484.htm> (accessed 5 September 2016).

36 IMF and World Bank (2011), *Managing Volatility in Low-Income Countries: The Role and Potential for Contingent Financial Instruments*

37 Chamon, M, and P Mauro (2005), *Pricing Growth-Indexed Bonds*

38 Buchanan, JM (1975), 'The Samaritan's dilemma', in ES Phelps (ed.), *Altruism, morality and economic theory*, Russell Sage Foundation, 71–85.

39 After the financial crisis, these stocks have also been significantly depleted.

40 In the case of CCPs targeting environmental shocks, such as Grenada's hurricane clauses, measurement and verification is well defined, meaning that moral hazard is not an issue.

41 IMF and World Bank (2011), *Managing Volatility*, op. cit.

4. Countercyclical Financial Instruments to Build Fiscal Resilience to Shocks

4.1 Genesis of the Commonwealth's programme on countercyclical finance

Since the outbreak of the 2007–09 global financial crisis, the Commonwealth Secretariat, as mandated by its membership, has advocated for the establishment of financial mechanisms that can help to build country resilience to exogenous shocks and counteract the significant debt challenges of its developing and small island member states. The Secretariat's work in this area has been demand-driven and shaped by the perspectives of its members, which have emerged through a series of outreach meetings in recent years. Notable among these have been a number of regional Commonwealth workshops on innovative finance solutions, organised and led by the Secretariat in 2013, and the Commonwealth's High-Level Advocacy Mission to IFIs in the same year, which proposed a set of policy solutions to remedy small states' development challenges.⁴²

The outcomes of this process pointed to the need for countries to build their fiscal resilience to exogenous shocks. Commonwealth member states that were highly vulnerable to exogenous shocks, and in some cases already facing significant debt sustainability challenges, were particularly interested in financial instruments that offered a stay on debt servicing in times of crisis.

4.2 Countercyclical provisions (CCPs)

CCPs are loan arrangements and debt securities that feature an ex-ante covenant, in which countries' debt service obligations are temporarily permitted to fall in response to an external shock, as measured in a predetermined way (for instance, through the use of parametric meteorological data to assess the severity and expected costs of a storm, or through the use of economic data to determine the impact of commodity price volatility on a country's terms of trade).

CCPs represent one instrument in the suite of index or risk-linked loans and securities, which include, *inter alia*, sovereign CoCo bonds and GDP-linked bonds. Unlike sovereign CoCos, which provide a maturity extension in the event that a country receives official sector liquidity assistance, CCPs are not contingent on countries receiving ex-post support packages. CCPs can, therefore, potentially be much quicker to take effect following a shock. GDP-linked bonds, which are designed to promote fiscal policy stabilisation, share similarities with CCPs because they enable issuers to benefit from a form of debt relief during an economic downturn. However, unlike GDP-linked bonds, CCPs do not offer symmetrical benefits to lenders and borrowers.

4.3 The utility of instruments with CCPs

CCPs offer three main benefits over existing ex-post shock-financing mechanisms:

1. **Safeguarding fiscal space and debt sustainability:** As assistance is pre-agreed, CCPs are quick to disburse and provide immediate liquidity following a shock. This helps to safeguard fiscal space during times of economic stress, without obliging countries to incur additional debt. In this manner, governments can accelerate post-shock economic recovery through the prioritisation of critical reconstruction, infrastructure and social welfare investments, without compromising their debt sustainability targets.
2. **Mitigating default:** A predetermined standstill on debt repayments would mitigate the likelihood of default by enabling countries to satisfy their debt obligations at a point in time when it is more economically viable for them to do so. For debtor nations, this flexibility could play an important role in helping to protect both the creditworthiness and the sustainability of public finances.

42 These included: countercyclical financing to mitigate debt accumulation and growth challenges; debt swaps for climate change adaptation and mitigation; vulnerability as a criterion for access to concessional resources; and resilience building as a policy condition for IFI lending.

3. **Avoidance of debt restructuring:** By reducing the likelihood of default, a repayment moratorium would also mitigate the need for countries to undertake costly debt restructuring operations. In the case of a significantly large shock, a standstill on repayments would, at a minimum, provide debtors with breathing room to facilitate an earlier engagement with their creditors. Ultimately, this could help to secure more orderly and less costly future debt restructuring operations.

4.4 The current CCP portfolio

Currently, there are a limited number of operative CCPs. The Commonwealth Secretariat has produced separate analysis on two substantive examples:⁴³ 1) countercyclical loans offered by the Agence Française de Développement (AFD), which provide countries with the option of debt service holidays in times of economic stress (see Box 4.1);

and 2) a series of hurricane clauses within Grenada's 2015 debt restructuring agreements, which enable the deferral of debt repayments for a predetermined period of time, or rapid debt restructuring in the event of a natural disaster (see Box 4.2).

In addition to these instruments, the IMF delivered a countercyclical support package, which enabled its African member states that were impacted by 2013–15 Ebola epidemic to benefit from a stay on debt servicing during the crisis. However, the IMF only agreed this flexibility ex-post – i.e. after the full extent of the Ebola epidemic became clear.⁴⁴

43 See Commonwealth Secretariat (2016) 'Extending Countercyclical Loans: Lessons from Agence Française de Développement' and 'Introducing Hurricane Clauses: Lessons from Grenada's recent experience'.

44 See Section 5 for a discussion on the IMF's countercyclical support package.

Box 4.1 The Agence Française de Développement's countercyclical loans

The Agence Française de Développement's (AFD's) countercyclical loan instruments were introduced in 2007, as part of its concessional loan portfolio. These products were designed to ensure that the future borrowing needs of low-income countries that benefitted from extensive levels of debt relief through the Highly Indebted Poor Country Initiative (HIPC) would be satisfied in a manner that did not compromise debt sustainability. To date, the AFD has established 16 countercyclical loans with five African countries, with an equivalent financial commitment of 344 million euros (€). The projects financed have been in the water, sanitation, electricity, road and education sectors.

The Prêt Très Concessionnel Contracyclique (PTCC) is AFD's concessional countercyclical loan – featuring a door-to-door tenor of 30 years, a five-year fixed grace period at the start of the loan and a five-year 'floating' grace period. This arrangement offers the right to defer up to ten semi-annual principal installments (whether consecutive or not) upon the occurrence of a 'triggering event' that is linked to falls in export earnings. This 'floating' grace period feature of the PTCC applies only to the principal, with the interest having to be paid in full and on schedule by the borrower, even if a triggering event has occurred. AFD also planned to roll-out a non-concessional countercyclical loan, known as the Prêt à Remboursement Variable et Reéchelonable (PRVR), but this instrument has never been demanded.

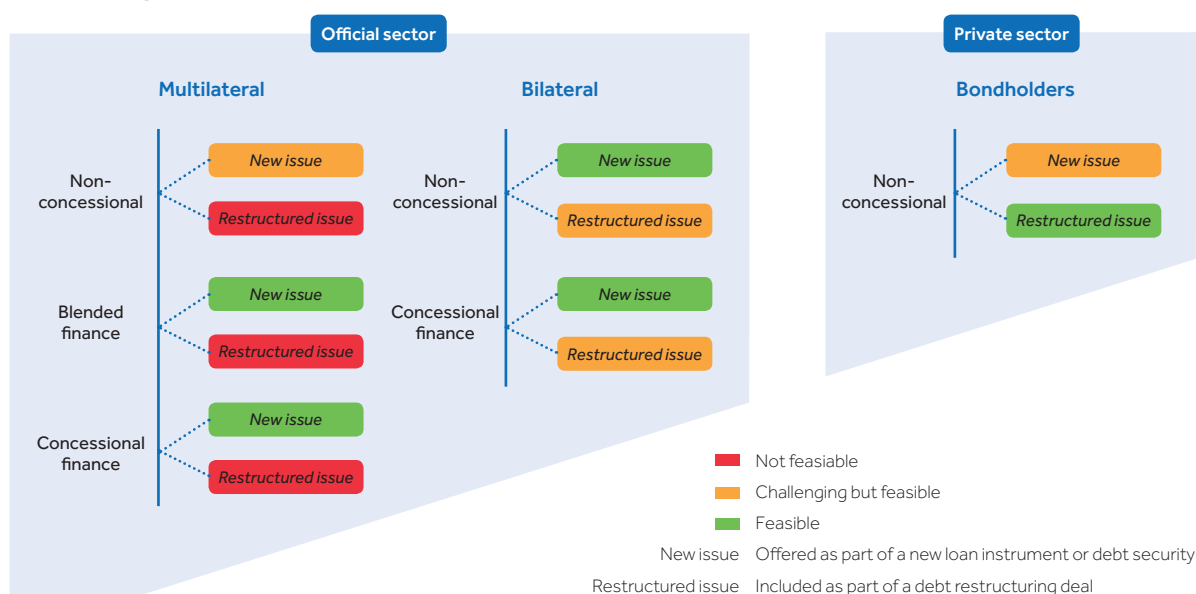
Box 4.2 Grenada's Hurricane Clauses

Hurricane clauses were included in all three of Grenada's debt restructuring deals in 2015, although their features differed markedly. The first deal secured was with the Export Import Bank of Taiwan (Eximbank). It featured a hurricane clause that enabled a stay on principal and interest payments if Grenada was hit by a hurricane, earthquake or excess rainfall, as measured by the Caribbean Catastrophic Risk Insurance Facility (CCRIF SPC), where losses exceeded US\$15 million. As part of this, Grenada would benefit from a 12-month debt repayment moratorium, following the verification of a natural disaster, which could be called on three times.

Grenada's 2025 bondholders took the Eximbank hurricane clause as a starting point, but decreased flexibility for the Grenadian government, insuring only against hurricanes and reducing the moratorium period in line with the size of CCRIF SPC's payout (6 months / 1 payment date if US\$15 m < CCRIF SPC payout is < US\$30; or 12 months / 2 payment dates if CCRIF SPC payout is > US\$30). Grenada's final deal with the Paris Club was more limited, and only provided the opportunity for a fast-tracked debt restructuring process in the event of a hurricane. As such, this deal arguably represented more of a political rather than a contractual commitment.

5. Opportunities for Taking Forward CCPs: Creditor Perspectives

Figure 5.1 Feasibility for implementing countercyclical financing provisions, by creditor type and lending window



Source: Author's investigation

5.1 Methodological approach

To gauge the potential for growing the share of countercyclical provisions (CCPs) in the international shock-financing architecture, interviews were conducted with credit rating agencies and official and private sector development finance providers.

Figure 5.1 illustrates the central inference: the feasibility of advancing countercyclical financing provisions varies across the categories of creditors considered in this study (multilateral development banks, bilateral development agencies and private sector bondholders) according to the financing modality (concessional or non-concessional) in question, and whether CCPs are incorporated into a new loan instrument / debt security issue or as part of a debt restructuring agreement. Approximately one-third of Commonwealth member states are eligible for either concessional or non-concessional development assistance, and one-fifth of members are eligible for blended finance (as shown in Figure 5.2).

A detailed overview of the principal challenges and opportunities for establishing CCPs that have

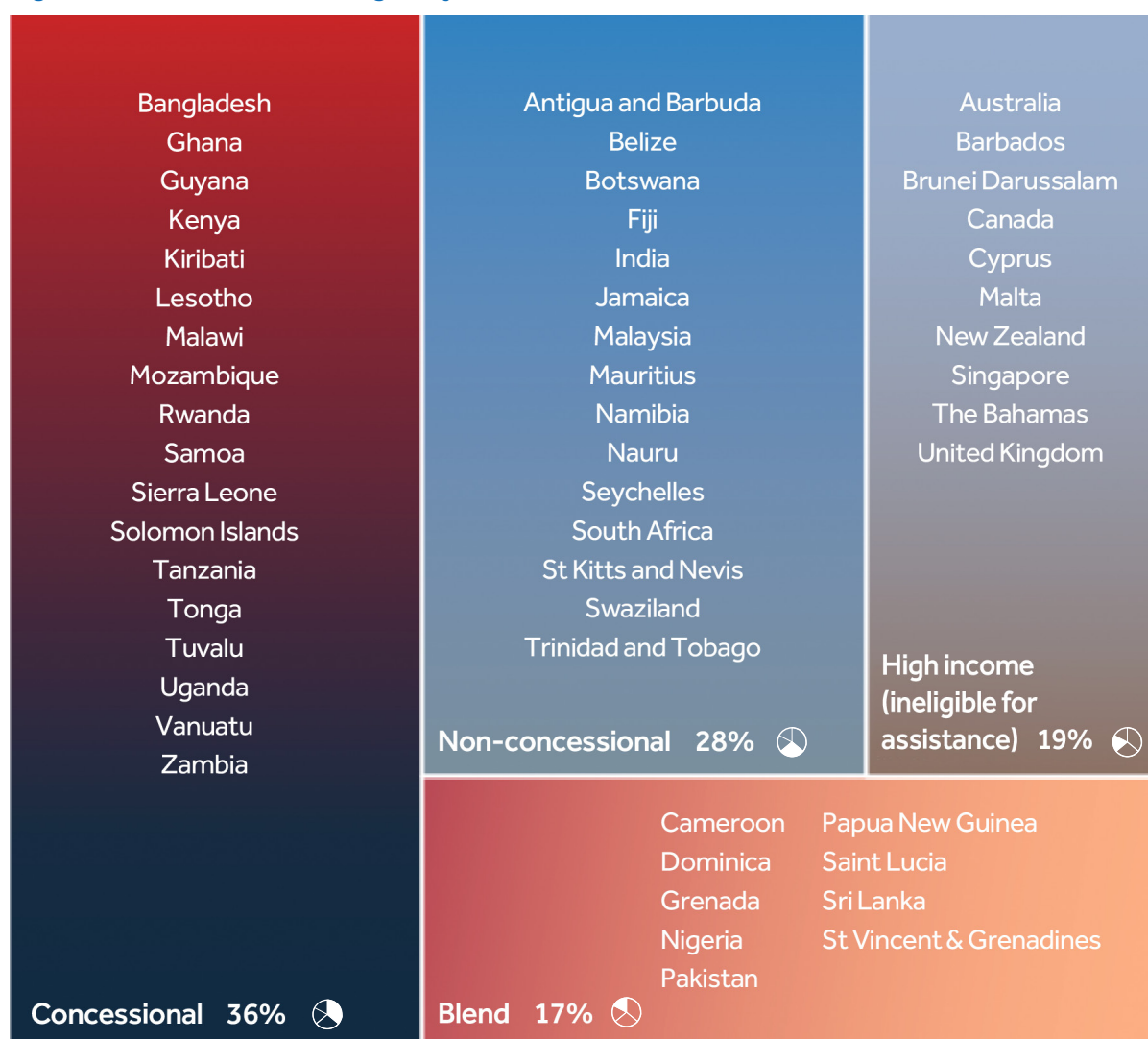
been raised by creditors is provided in the following subsections.

5.2 Multilateral development banks

5.2.1 Non-concessional financing

New instrument issue: The potential for multilateral development banks (MDBs) to incorporate CCPs within their hard-lending windows is a function of their financial model: supported by strong credit ratings, MDBs are able to acquire resources from international capital markets at a competitive cost for on-lending on more attractive terms than their borrowing member countries would be able to negotiate independently. While the determinants of credit ratings are multifaceted,⁴⁵ MDBs have been able to maintain credit strength over several

⁴⁵ Key rating metrics for supranational institutions include capital adequacy; shock absorption capacity; member country paid-up and callable capital contributions; portfolio concentration risk; balance sheet vitality, especially with regards to the share of non-performing loans; and the quality of risk management, monitoring processes and bank governance structures.

Figure 5.2 Commonwealth eligibility to finance, 2016

Sources: Policies and Procedures. World Bank, 2016 (<https://policies.worldbank.org/sites/ppf3/PPFDocuments/Forms/DispPage.aspx?docid=3680&ver=current>)

decades, primarily by upholding their track record of punctually reimbursing their bondholders.

Underscoring the importance of this relationship, multilateral creditors generally expressed concerns about the systematisation and large-scale roll-out of CCPs, citing the threat presented by cash-flow disruptions to their current resource mobilisation model. Multilaterals further observed that loans featuring a callable stay on debt repayments would, by incorporating some form of permitted default mechanism, be incompatible with their historically aggressive stance when countries have failed to meet the legal obligations of their loans.⁴⁶ Nevertheless, the proportion of an MDB's portfolio that would have to be offered and demanded in a CCP format for creditworthiness to be impacted remains to be ascertained.

Credit rating agencies (CRAs) have largely supported the concerns raised by MDBs, highlighting the potential for cash-flow disruptions to aggravate liquidity and solvency positions. However, one solution for tendering countercyclical flexibility while preserving creditworthiness, which CRAs agreed could be feasible, would be for MDBs to exploit the derivatives market to hedge against cash-flow risk. The World Bank's International Bank of Reconstruction and Development (IBRD) recently considered this option to support a loan arrangement for Colombia, as outlined in Box 5.1.

⁴⁶ This has, for instance, entailed the cessation of additional lending until debts have been serviced, or the deterioration of lending terms in future loan agreements, reflecting escalating risk premiums for jurisdictions that are expected to or have recently defaulted.

Box 5.1 The IBRD and Colombia: Exploiting the derivatives market to hedge against cash flow risk

- Colombia is the IBRD's fifth largest debtor. Its annual repayments to the IBRD are projected to be particularly onerous in the coming years, ranging from US\$300 to US\$400 million annually.
- Concerned that its vulnerability to earthquakes could compromise its debt servicing capacity, Colombia worked with the IBRD to develop a repayment interruption option (RIO). The RIO was intended to effectively transfer debt repayment obligations from the Government of Colombia to private investors.
- This flexibility was envisioned to be facilitated through the issuance of a weather derivative, funded by Colombia, that would pay out in the event of an earthquake striking Colombia that significantly impacted its growth prospects. This pay out would be used to service the principal and coupon costs of Colombia's debt to the IBRD.
- Considering that the cost of issuance would be too great to bear, Colombia ultimately opted against taking out this financing arrangement.

Restructured instrument issue: It is likely to prove challenging for MDBs to incorporate CCPs into restructured instrument issues, as to date, debt restructuring is only been undertaken by middle-income countries to address solvency challenges on a limited basis.

5.2.2 Concessional financing

New instrument issue: The soft-lending arms of MDBs are capitalised through contributions from their member governments. As such, credit-rating considerations have not restricted multilaterals from incorporating CCPs in their concessional instrument portfolio. However, such flexibility has, to date, only been offered on a limited and ad-hoc basis.

The response of the IMF to the Ebola crisis provides one example. With clear political impetus from the G20,⁴⁷ and amid wider criticisms of the Fund's approach to macroeconomic adjustment and sector-level decision making,⁴⁸ the IMF acknowledged that countries with a high exposure to the 2013–15 West African Ebola virus epidemic may have been unfairly circumscribed, through their obligations to the Fund, to prioritise debt repayments over critical public service investments, limiting the quantity of health professionals that could be rapidly mobilised. In response, the IMF took a major step to rapidly ease pressures in Guinea, Liberia and Sierra Leone by approving a temporary stay on debt servicing, and by providing a combination of concessional loans, debt relief and grants for severely impacted countries.⁴⁹

The IMF's mandate – to advance international economic co-operation and promote financial stability – is singular and arguably the most amenable to the implementation of

countercyclical finance. It is currently reviewing its position on state-contingent financial instruments for consideration by its Executive Board in early 2017.

For other MDBs, which instead focus on providing support for long-term economic development, countercyclical finance presents an opportunity cost: finite resources provided by contributing member governments must be ring-fenced to provide the necessary financial buffer to cover the cost of a triggered grace period. This would entail some diversion of resources away from country allocations for long-term development projects. The World Bank's increasing participation in the provision of shock financing, through its International Development Association (IDA), encapsulates this trade-off. 80 per cent of IDA's portfolio in FY15 was devoted to investment lending, with another 20 per cent reserved for other purposes, including shock facilities such as the Immediate Response Mechanism and the Crisis Response Window. Even though the demand for the World Bank's Credit Response Window has continued to exceed supply, with more resources sought in the first year of the IDA17 cycle than the total amount delivered in IDA16,⁵⁰ IDA member countries have generally been averse

47 The White House (2015), *G20 leaders' Brisbane statement on Ebola*, available at: <https://www.whitehouse.gov/the-press-office/2014/11/15/g20-leaders-brisbane-statement-ebola> (accessed 5 September 2016).

48 Centre for Global Development (2007), *Does the IMF Constrain Health Spending in Poor Countries?*

49 International Monetary Fund (2015), *IMF response to the Ebola crisis*, op. cit.

50 International Development Association (2016), *Setting the Agenda for IDA18: Strategic Directions*.

Box 5.2 Scaling-up CCPs through blended finance and trust funds

One potential option for multilateral providers to circumvent credit-rating considerations related to the provision of countercyclical financing mechanisms (as outlined in Section 1.1) could be to ring-fence resources as part of a trust fund, capitalised through a blended finance arrangement.

The advantage of such an approach would be to moderate the diversion of capital away from long-term investment projects, through the diversification of the capitalisation base from both concessional and non-concessional funds. Provided that appropriate legal requirements can be secured in a manner that safeguards the MDB's liquidity and solvency positions, credit-rating agencies have indicated that such an arrangement could represent a practical option for funding CCPs without compromising credit status. It remains unclear, however, if trust funds would be able to sustainably mobilise resources to support the provision of countercyclical financing instruments on a large scale.

to enlarging crisis response operations at the cost of diminishing the pool of resources available for investment lending.

Restructured instrument issue: After the significant quantum of debt relief provided as part of both the Multilateral Debt Relief Initiative (MDRI) and the Highly Indebted Poor Country Initiative (HIPC),⁵¹ the political climate is not conducive for MDBs to engage in further large-scale debt restructuring, limiting the prospects for incorporating countercyclical flexibility as part of revised financing agreements.

5.3 Bilateral development agencies

Bilateral development agencies have shown the greatest ambition to take CCPs forward, and have provided the key examples of this innovation to date. Our engagements revealed that the feasibility for bilateral creditors to offer CCPs is equivalent across their non-concessional and concessional operations, reflecting a common set of precedential and legislative considerations.

New instrument issue: The Agence Française de Développement (AFD) has played a pioneering role through the introduction in 2007 of its concessional countercyclical loan, the Prêt Très Concessionnel Contracyclique (PTCC). The cost of the PTCC for AFD is equal to AFD's other highly concessional loans. These loans are subsidised and financed through a grant and a concessional loan arrangement from the French Treasury. The dimensions of the Treasury's support, therefore, represent the key determinant for scale-up. The extent to which the treasury offices of other Paris Club member states can replicate AFD's model, and generate a significant quantum of resources for the provision of countercyclical assistance, remains to be seen. Nevertheless, AFD's countercyclical portfolio, at a minimum, provides an operative CCP example for other lenders to learn from and adapt to their specific circumstances.

Restructured instrument issue: In 2015, Grenada saw the precedent-setting introduction of a series of hurricane clauses, which enabled the deferral of debt repayments for a predetermined period of time, or the activation of a fresh round of restructuring, in the event of a hurricane or other natural disaster. Grenada's restructuring agreement with the Export Import Bank of Taiwan (Eximbank) served to illustrate how a CCP, allowing for considerable flexibility, can be attained as part of a restructured loan arrangement. This variant of the hurricane clause was the most ambitious, and was also most closely aligned to preferences of the Government of Grenada.

In comparison, the hurricane clause secured by Grenada with the Paris Club was regarded to be more of a political than a contractual assurance.⁵² Paris Club negotiations were primarily constrained by the challenges of consensus decision-making. In this instance, concerns about precedent setting and the requirement from some of the Paris Club's members that debt treatments must receive parliamentary approval before they are granted, limited the flexibility provided in the final version of the instrument.⁵³ Although this agreement has

51 The IMF delivered approximately US\$3.4 billion in nominal terms in MDRI debt relief, while the total cost of providing assistance to the 39 countries that have been found eligible or potentially eligible for debt relief under the enhanced HIPC Initiative was estimated to be about US\$75 billion in end-2014 net present value terms. See: IMF (2016), 'The multilateral debt relief initiative', Factsheet; and IMF (2016), Debt Relief Under the Heavily Indebted Poor Countries (HIPC) Initiative.

52 The Paris Club's clause simply provides the opportunity for fast-tracking debt restructuring operations in the event of a hurricane. For discussion of this clause, please refer to Commonwealth Secretariat (2016) 'Introducing Hurricane Clauses, Lessons from Grenada's Recent Experience'.

53 This process can entail often-prolonged, time-consuming and challenging negotiations with legislators.

laid the foundations for more meaningful hurricane clauses (providing that they embody a political priority for Paris Club members), it remains unclear whether Paris Club creditors would be able or willing to implement more ambitious versions of CCPs. Based on Grenada's experience, other non-Paris Club development finance providers, such as China, may have greater scope to advance ambitious CCPs.

5.4 Bondholders

New instrument issue: Given their relatively exotic and complex nature, some investors have argued that state-contingent debt instruments are challenging to price accurately and competitively.⁵⁴ In the case of bonds with CCPs, complexity in determining the yield to maturity presents the most fundamental challenge, reflecting changeability in the profile of expected coupon and principal repayments after the occurrence of a shock. Furthermore, as a result of their greater flexibilities relative to financial arrangements without optionality, CCPs may only be able to be offered at a premium, which would make them costlier to issue in comparison to conventional debt securities. From the creditor perspective, a key area of concern relates to cross-subsidisation, due to the potential

preferential treatment that would be given to non-hurricane clause bondholders after clauses have been triggered.

Yet, despite these constraints, healthy markets exist for comparable instruments that were anticipated to be challenging to value, such as inflation-indexed bonds.

Restructured instrument issue: The precedent-setting inclusion of a hurricane clause from Grenada's 2025 bondholders demonstrates that private sector creditors are open to innovative countercyclical approaches. Negotiations were helped by creditors' knowledge of the region and its hazards, and their shared sympathy to Grenada's argument for hurricane provisions, which was deemed to be both credible and compelling. Bondholders also had a clear incentive to secure a deal, as Grenada was defaulting on its financial commitments. For other countries to benefit from similar provisions, it is clear that an equally strong case will need to be presented to creditors concerning their vulnerability to shocks and the risk that this poses to their capacity to recompense bondholders.

54 Chamon and Mauro (2005) *Pricing Growth-Indexed Bonds*, op. cit.

6. Conclusion

Increasing environmental and economic risks have established the imperative for countries to consolidate their risk management strategies. Exogenous shocks are on the rise, and continue to impose significant costs for developing countries. The analysis undertaken in this paper has, therefore, commenced from the starting point that the greater utilization of ex-ante shock financing mechanisms is necessary to mitigate growth and welfare losses associated with adverse exogenous events.

This paper has examined the potential for growing the share of ex-ante CCPs as one in a range of complementary risk management instruments for sovereign borrowers. In times of shock, these provisions can help countries to safeguard fiscal space and debt sustainability, through the provision of immediate liquidity. The analysis undertaken establishes that the opportunities for scaling-up CCPs are likely to be greatest in the case of restructured bonds financed by private investors, and loans provided by both bilateral development agencies and the concessional and blended-finance windows of multilateral development banks.

Although the operative examples of CCPs are currently limited, both in terms of their volume and their flexibilities, the introduction of countercyclical provisions in the form of Hurricane Clauses by the Government of Grenada and its creditors, and by the Agence Française de Développement, through its countercyclical loan portfolio, has helped to lay the groundwork for other development finance providers and sovereign borrowers to implement and harness the benefits of CCPs.

With growing economic uncertainty, and climate change as an unprecedented long-term environmental concern, a change of thinking 'from business as usual' will be necessary among development finance providers to facilitate prompt, responsible, and sustainable lending to those jurisdictions that are most exposed and vulnerable to exogenous shocks. This would also play a critical role in helping creditors to minimise their own resultant losses.

In the global context, the greater provision and employment of the broad range of ex-ante financing mechanisms, including CCPs, can complement existing international initiatives to mitigate the impacts of climate change; contribute to efforts to establish a

credible and efficient sovereign debt workout process; and support post-2015 policy frameworks on disaster risk management, such as the Sendai Framework for Disaster Risk Reduction.

There is now a need for creditors and debtors to give consideration to how they can most effectively structure financial instruments to respond to this new environment. Successful market development will necessitate efforts to identify the configuration of an 'ideal' or 'model' CCP arrangement that effectively marries debtor and creditor interests. As part of this, development finance providers will need to reflect on a number of instrument design considerations including, *inter alia*, the choice of trigger; relevant data sources for verifying the occurrence and economic impact of a shock; the debt servicing moratorium period; the optimal level of instrument complexity; and the associated cost premium. Premiums attached to CCP arrangements will be a key demand-side determinant. If these prove to be too onerous for debtors to bear alone, one option could be to partially share any costs associated with the provision of flexible repayment schedules between lenders and borrowers, as both lenders and borrowers stand to gain from the buffer that CCPs provide.

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