



Corporate Evaluation

Contingent Lending Instruments

Contingent Lending Instruments

Office of Evaluation and Oversight, OVE



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ACRONYMS AND ABBREVIATIONS

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ADB	Asian Development Bank
ADF	Asian Development Fund
bps	basis points
CAF	Development Bank of Latin America
CAT DDO	DPF with a catastrophe DDO
CCF	Contingent Credit Facility for Natural Disaster Emergencies
CCL	Contingent Credit Line (IMF)
CCL	Contingent Credit Line for Natural Disasters (IDB)
CCL	Contingent Credit Line for Natural Disasters (CAF)
CCRIF	Caribbean Catastrophic Risk Insurance Fund
CFF	Compensatory Financing Facility
CSF	Countercyclical Support Facility
DDO	Deferred Drawdown Option
DPF	Development policy financing
DSL	Development Sustainability Credit Line
EMBI	Emerging Market Bond Index
FCL	Flexible Credit Line
FEE	Fondo de Estabilización de Energía
FSO	Fund for Special Operations
GDP	Gross domestic product
HAPA	High-Access Precautionary SBA
IAMC	Independent Assessment of Macroeconomic Conditions
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IDB	Inter-American Development Bank
IDB-9	IDB's Ninth Capital Increase
IDRM	Country Integrated Disaster Risk Management Program
IFI	International financial institution
IMF/Fund	International Monetary Fund
IPF	Investment project financing
IRM	Immediate Response Mechanism
LAC	Latin America and the Caribbean
LIC	Low-income country
LTFP	Long-Term Financial Planning
MDB	Multilateral development bank
OC	Ordinary capital
OVE	Office of Oversight and Evaluation
PBL	Policy-based loan
PCL	Precautionary Credit Line
PFF	Precautionary Financing Facility
PFO	Precautionary Financing Option
PLL	Precautionary and Liquidity Line
SBA	Stand-By Arrangement
SCF	Stand-By Credit Facility
SG	Sovereign-guaranteed

SPD	Office of Strategic Planning and Development Effectiveness
SPV	Special-Purpose Vehicle
UBC	Unused Borrowing Capacity
WB	World Bank

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Executive Summary

Financial and economic crises and natural disasters can have serious and lasting negative effects on income and poverty, and can cause irreversible losses of physical and human capital. The welfare effects of exogenous shocks have prompted multilateral development banks (MDBs), including the Inter-American Development Bank (IDB), to provide crisis lending to their borrowing member countries to avoid retrenchments in development caused by crisis-related fiscal pressures. In doing so, MDBs have added to the array of crisis risk management options that countries have at their disposal. By providing funds for natural disaster relief efforts, MDBs have in part compensated for the low levels of disaster risk insurance many developing countries have. In lending for financial and economic shock situations, MDBs are complementing countries' self-insurance measures (e.g., reserve accumulation), prevention measures (e.g., debt reduction and currency denomination), and support by the International Monetary Fund (IMF).

The Board of Executive Directors has requested that the Office of Evaluation and Oversight (OVE) conduct an independent assessment of IDB's contingent instruments designed to help countries cope with shocks. OVE's review is meant to inform a forthcoming study by the Office of Strategic Planning and Development Effectiveness aimed at proposing alternatives to better align Bank instruments to country financing and development needs, including countercyclical support.

The extent to which, and how, the IDB can and should dedicate its finite resources to crisis lending is a decision for the governance bodies of IDB—the Board of Governors and the Executive Directors. Rather than issuing specific recommendations, this review focuses on highlighting relevant trade-offs and issues to bear in mind when considering this topic.

MDB lending for financial and economic crises faces questions of mandate and capacity. Some observers see the IMF as better suited to act as international liquidity lender of last resort because of its inherent role and large capital base (Cordella and Levy Yeyati 2005; Forbes 2006), while some stakeholders make a case for countercyclical crisis lending by MDBs.¹ OVE’s review has found no clear consensus on the extent to which MDBs should regularly offer contingent and emergency lending for financial and economic shocks.² Setting funds aside to be available for countercyclical crisis lending in bad times implies lower lending for development during tranquil times. This opportunity cost is exacerbated for regional development banks such as the IDB, whose risk diversification options are constrained, given their more limited number of borrowers, which often have similar vulnerabilities.

Crisis lending can take the form of emergency lending, which is approved after a shock hits, or contingent lending, which is typically approved before a crisis materializes. Contingent lending is meant to guarantee the availability of funds in anticipation of an actual financing need, usually conditional on the occurrence of a certain state or event. While the IDB had traditionally focused on ex-post emergency lending, in 2012 (AB-2890) it replaced its dedicated Emergency Lending Category with a contingent instrument, the Development Sustainability Line (DSL). At the same time, it introduced a contingent modality—the Deferred Drawdown Option (DDO)—for its policy-based loans (PBLs); created a new contingent product, the Contingent Credit Line for Natural Disasters (CCL); and increased the limits available under the Contingent Credit Facility for Natural Disaster Emergencies (CCF), established in 2009.

Unlike the PBL DDO and CCF, amounts approved under the DSL and the CCL were designed to be additional to countries’ regular sovereign-guaranteed (SG) lending envelopes. Funds for the DSL and CCL were to come from temporary additional lending capacity created by IDB-9 capital contributions (for the DSL) and from reductions in the Unused Borrowing Capacity buffer (for the CCL) in 2012. Since 2012, however, the IDB’s capital has become more constrained and the availability of funds for the DSL and CCL less clear. In contrast, PBL DDO and CCF approvals have always counted as regular Bank lending, with the CCF being primarily used as a mechanism to allow funds from previously approved investment projects to be diverted for relief efforts in case of a catastrophic natural disaster.

Demand for these instruments has been limited. The DSL had very low uptake,³ and was allowed to expire at the end of 2015. No countries have requested a CCL operation, and only two countries—Uruguay and Peru—have used the PBL DDO so far. The CCF has been more popular, with seven countries⁴ using it.

Other international financial institutions (IFIs) also offer contingent financing products for shock events. The IMF provides various contingent lending instruments for balance-of-payments crises, differentiated by their trade-offs between ex-ante and ex-post conditionality.⁵ Like the IDB, other MDBs have put in place contingent financing for economic and financial crises (ADB, CAF), general liquidity needs, including shocks (World Bank), and natural disasters (World Bank, CAF). The World Bank also acts as intermediary between countries and markets for certain geo-meteorological risks.

Demand has also been low for other IFIs' contingent lending instruments, specifically those for economic and financial shocks. OVE found that the limited use of contingent instruments seems to be rooted mainly in (i) the general stigma of potentially revealing vulnerability to an uncertain future event, and (ii) specific instrument design factors, such as pricing and the requirements for drawdown.

LESSONS LEARNED FROM IDB AND OTHER IFI EXPERIENCE

Most countries have not been willing to pay a significant premium over regular lending terms for contingent instruments. This is especially true for standby fees, which must be paid before a crisis occurs. This implies that for most countries the advantages of contingent instruments (such as potential positive signaling effects and more certainty of quick disbursement of funds) do not outweigh their cost and other drawbacks.

Uniform pricing across countries creates certain issues for the provision of contingent lending products. Risk-based access restrictions (used instead of risk-differentiated pricing) have resulted in unclear eligibility criteria, reduced support for the instrument class itself, and potential stigma rooted in asymmetric information about country risk.

The degree of borrowers' certainty about their eligibility for quick disbursement affects demand. This realization has led the World Bank to shift the responsibility for maintaining and communicating disbursement eligibility status from the borrower to the World Bank. In contrast, the IDB's DSL and CCL rely on "close policy dialogue" during the drawdown period, which leaves the specific mechanics and responsibilities unclear.

Requiring a valid Independent Assessment of Macroeconomic Conditions (IAMC), in its current form, for disbursement⁶ under the DSL and CCL has been seen as interfering with the goal of these instruments to respond to shock situations. Given that exogenous shocks of a sufficient magnitude often affect countries' macroeconomic outlooks, eligibility for the DSL and CCL can be compromised by the same shocks that the instruments are meant to protect against. The IAMC considers both endogenous and exogenous factors in judging the state of a country's macroeconomic condition, whereas the macroeconomic assessments of the World Bank and ADB focus on the strength of the economic frameworks that are under the country's control.

Other factors mentioned in connection with the low demand for the DSL and CCL were (i) uncertainty as to whether resources were in fact available, and (ii) limited knowledge of these tools.

The poorest countries typically do not have access to contingent lending instruments for financial and economic crises. Only the IMF's Standby Credit Facility (SCF) can be used by low-income countries in a precautionary way.

There are alternatives to MDBs' covering of risks for which there is market appetite. The World Bank's experience has shown that MDBs can directly address market failures impeding insurance against natural disasters by intermediating between countries and markets, instead of or in addition to assuming risks on their own balance sheets.

SUGGESTIONS AND CONSIDERATIONS FOR THE UPCOMING REVIEW OF SG LENDING INSTRUMENTS

Decisions around whether – and, if so, how – to reintroduce emergency and/or contingent lending products need to strike a reasonable balance between the interests and constraints of the IDB and its various member countries and can be informed by recent IDB and IFI experience. Given the importance and complexities of the decisions involved, OVE's main suggestion is to conduct careful and comprehensive stakeholder consultations regarding needs and preferences concerning the following:

- (i) IDB's countercyclical role and capacity
- (ii) Joint (in the form of a capital buffer) vs. individual (within countries' lending envelopes) saving for bad times
- (iii) Options for lending instruments:
 - a. Emergency vs. contingent (vs. both) lending
 - b. Financial and nonfinancial terms and conditions
 - c. Expanding eligibility to more countries
- (iv) Demand and IDB capacity as a risk intermediary.

¹ In addition to avoiding reversals in development gains, some observers argue that MDB crisis lending may fill gaps left by the IMF's potentially more restrictive definitions of crisis events covered (balance of payments only) and of eligible borrowers (central banks). Source: OVE interviews and various IDB documents, e.g., AB-2980.

² At the IDB, for example, a 2010 Management proposal (GN-2564-1, not approved) argued for eliminating the emergency lending category because of the IMF's introduction of a new contingent product, the Flexible Credit Line.

³ Only Ecuador and El Salvador have used the DSL. Ecuador's DSL operation was disbursed shortly after its 2014 approval, and El Salvador cancelled its DSL line at the end of 2015.

⁴ Dominican Republic, Honduras, Ecuador, Panama, Costa Rica, Peru, and Nicaragua.

⁵ *Ex-ante conditionality* refers to the instrument's up-front qualification requirements. *Ex-post conditionality* refers to the conditions precedent for drawdown under the instrument. The Flexible Credit Line (FCL) is reserved to countries with very strong economic fundamentals, but allows for automatic drawdowns upon request. The Precautionary Stand-By Arrangement (SBA), and its high-access variant, the HAPA (High-Access Precautionary SBA), by contrast, offer access also to economically weak countries, but disbursements are contingent on agreed policy implementation. The Precautionary and Liquidity Line (PLL) falls between the FCL and the SBA, in that the instrument is limited to economically sound countries, but disbursements still hinge on certain conditionality related to remaining vulnerabilities. Low-income countries—which do not qualify for FCL, PLL, SBA, or HAPA—may use the Stand-By Credit Facility (SCF) in a precautionary way.

⁶ The IAMC requirement for approval seems to be less of a concern, unless a purely external shock is already under way and influencing the IAMC.



1 Introduction

Since the early 2000s, the IDB has provided financial support to its sovereign clients through three lending categories: investment loans, emergency loans, and policy-based loans. Investment loans finance the cost of individual projects to support institutional development and the creation and rehabilitation of social or economic infrastructure. Policy-based loans (PBLs) support institutional and policy changes at the sectoral or subsectoral level through fast-disbursing funds (thus also contributing to meeting countries' financing needs). The Emergency Lending Category was created in 2002 (based on the experience of a brief 1998-99 Emergency PBL program) to allow the Bank to respond to financial crises in the Region. In 2012, this category was replaced by the Development Sustainability Credit Line (DSL), a contingent instrument¹ to be approved ex ante (i.e., before a crisis materializes) to cover urgent financial deficits or balance-of-payment needs in countries facing exogenous economic shocks, conditional on the protection of pre-identified programs and expenditures. The DSL was approved for 2012 to 2015, and was allowed to expire² at the end of 2015.

Over the last few years, the Bank has created an array of instruments under each of the three lending categories to assist countries in times of external economic shocks and natural disasters. Initially, most of the Bank's assistance to countries in times

of crisis was ex post, providing resources when a shock had already materialized. Emergency lending modalities fall under this category: countries demand an emergency loan after the shock has occurred, and approval by the Bank's Board of Executive Directors follows the crisis. However, since the 2008-2009 global financial crisis (and, in particular, since IDB's Ninth Capital Increase—IDB-9—in 2012), the Bank has established several contingent credit lines and facilities designed to help countries prepare ex ante for exogenous shocks.

The Office of Evaluation and Oversight (OVE) has conducted several assessments of the Bank's instruments, including financing modalities to help countries deal with exogenous shocks. In 2001, OVE focused on the IDB's Emergency PBLs during the 1998 crisis (RE-251) and concluded that the fact that emergency resources were not withdrawn as rapidly as the Bank anticipated could be evidence that "the announcement of an international support package including IDB participation had a calming effect on markets disoriented by contagion." In 2004 and 2008, OVE evaluated the emergency lending category that had been established in 2002 (RE-300 and RE-342-1). OVE recognized that loans in this category had usually been successful in accomplishing their country finance objectives, although the long-term returns to IDB's financial support were difficult to establish, and that there may have been "crowding effects which have on occasion generated some inappropriate matching of instruments to country needs." Overall, OVE recommended retaining emergency lending while revisiting the terms to make the loans less costly: "Given that such financing is needed at times of particular financial vulnerability, the current practice of charging higher rates and requiring shorter amortization periods on such lending should be re-examined and possibly be replaced with terms and conditions more suited to borrower capacity to repay." In 2013, OVE produced a background paper on IDB's lending instruments as part of the IDB-9 Mid-term Evaluation (RE-446-3). The evaluation did not include an analysis of the emergency lending category per se, but it welcomed the creation of new products (including the DSL and a Contingent Credit Line for Natural Disasters) as a way to increase the flexibility of the Bank's overall lending instruments to mitigate shocks. Finally, in 2015 OVE prepared a study on the design and use of PBLs at the Bank (RE-485-6). It found that the predominant motivation for using PBLs (including the Deferred Drawdown Option modality) is that they provide budget support to meet financing requirements; while they have played a major financing role, their countercyclical impact has been generally limited (and heterogeneous across countries). Moreover, the evaluation pointed to the need to reflect on the instrument's complementarity and substitutability with (more expensive and shorter-maturity) emergency and/or contingent lines.

In light of the recent expiration of the DSL, the Board of Executive Directors requested that OVE conduct an independent assessment of IDB's contingent instruments that are designed to help countries cope with shocks. The Office of Strategic Planning

and Development Effectiveness (SPD) is carrying out a study aimed at proposing alternatives to better align Bank instruments to country financing and development needs. This will include assessing how effectively the Bank provides countercyclical financing (GN-2837). Given OVE's recent review of the Bank's policy-based lending and its contribution to the discussion on IDB's countercyclical financing role, the Board of Executive Directors has asked OVE to provide an independent view on contingent lending instruments, to serve as input for SPD's forthcoming review of sovereign-guaranteed (SG) lending products.



2 Conceptual Background

Financial crisis events and natural disasters can have lasting negative effects on income and poverty, causing irreversible losses of physical and human capital. The evidence also suggests a close relationship between output volatility and inequality (Calderón and Levy Yeyati 2007, Halac and Schmukler 2004), ultimately challenging poverty reduction efforts. High volatility and crises in developing countries can be due to exogenous shocks (such as shifts in the terms of trade, financial external shocks, and natural disasters) or have their roots in such domestic factors as lax fiscal policies and debt management decisions. Monetary and fiscal policies, which should mitigate the effect of external shocks, have often been procyclical in developing countries (Fatas and Mihov 2012). It has been estimated that for 1970-2005 roughly half of “excess” volatility in developing countries (as measured against the benchmark of volatility in industrial countries) was associated with exposure to exogenous shocks (Perry 2009).

In dealing with high volatility caused by exogenous shocks, developing countries have a wide range of strategies and financial tools at their disposal (Table 2.1 and Perry 2009). Governments can wait for shocks to happen and then cope with them, or they can take precautionary measures to try to reduce their exposure to, and mitigate the impact of, shocks. During capital account crises, for example, governments may be forced to undertake procyclical fiscal adjustments to cover liquidity shortfalls. Ex-ante mitigation measures—for example, reducing debt levels and foreign currency exposure—may reduce the need for such adjustments. Self-insurance, through the accumulation of international reserves, can also reduce the impact of a capital flow shock. Finally, governments can buy insurance or enter into hedges with third parties to reduce liquidity and currency risks. Insurance or hedging instruments available to governments include contingent credit lines as well as bilateral liquidity or currency swap arrangements.

TABLE 2.1. MOST COMMON TOOLS FOR COUNTRIES TO DEAL WITH EXOGENOUS SHOCKS

	<i>Ex post</i>	<i>Ex ante</i>		
Type of shock	Coping after the shock	Prevention mitigation/preparedness	Self-insurance	Insurance/hedging/contingent borrowing
Terms of trade	Current account and (procyclical) fiscal adjustment Aid Emergency loans	Export diversification	Stabilization and other funds	Contingent credit lines Commodity price futures, forwards, and options Indexed debt (e.g., to terms of trade, commodity prices)
Capital flows	Current account and (procyclical) fiscal adjustment Aid Emergency loans	Debt level and composition Domestic capital market development De-dollarization	International reserves and other funds	Contingent credit lines Currency and interest forwards, swaps, and options Indexed debt (e.g., to GDP) External debt in domestic currencies
Natural disasters	Fiscal adjustment or reallocation Aid Emergency loans	Zoning and building codes, retrofitting Strengthening response capacity (e.g., through integrated disaster risk management systems)	Emergency and other funds	Insurance and reinsurance Contingent credit lines Catastrophe bonds

Source: OVE, adapted from Perry (2009).

Depending on the likelihood and costs of the diverse shocks countries can be exposed to, governments choose which risk strategies to apply. For events of high frequency and high expected cost, the emphasis arguably should be on prevention or self-insurance. For low-income countries, however, self-insurance measures—especially holding large reserves—can have high opportunity costs (IMF 2011). For rarer and more costly shocks, the best strategy could be contingent debt tools and insurance or reinsurance mechanisms (Erlich and Becker 1972). Finally, for phenomena that have an even lower probability of occurrence but that can be of a catastrophic scale, the optimal strategy might be ex-post emergency financing, since full prevention or insurance may prove too costly for hazardous events that have a very low likelihood of occurrence.

Given the often large welfare costs of exogenous shocks, multilateral development banks (MDBs) have stepped in to add to the tools countries have available for risk management. In addition to providing ex-post crisis loans and grants, MDBs have also started to offer instruments that can help countries mitigate exogenous shocks ex ante. Ex-ante arrangements, such as contingent lending, are safety nets meant to guarantee the swift availability of funds in case of an actual financing need. These arrangements are approved before a crisis strikes and require borrowers to spend resources today (e.g., in the form of standby and/or front-end fees) to reduce the consequences of an unknown

future event (Freeman et. al, 2003). Some MDBs also participate in market instruments: the MDB acts as an intermediary or market creator by guaranteeing or partially financing a private sector financing, hedging, or insurance instrument.

MDB crisis financing has often been restricted to events outside a country's control, such as natural disasters and exogenous economic and financial shocks. Thus, in an effort to address short-term liquidity rather than structural solvency issues (see AB-2890), MDBs try to exclude crises stemming purely from failures in domestic policies. The distinction between exogenous and endogenous shocks is not always straightforward, however, as domestic policies can often influence, if not the occurrence of the event itself, the size of the impact and thus the need for assistance. This raises a moral hazard issue: if a country is protected against a costly risk, it might have fewer incentives to take adequate prevention measures to avoid a crisis. Because of this, contingent credit lines typically involve close monitoring of eligibility conditions (such as maintaining sound macroeconomic policies or investing in disaster risk management systems) and limit coverage to exogenous shocks to reduce moral hazard and asymmetric information.

With contingent lending for natural disasters, MDBs are trying to compensate for countries' insufficient levels of insurance against such events.³ While private insurance may be seen as the first-best option to mitigate rare but costly exogenous shocks (such as natural disasters), such insurance can be expensive or unavailable because of (i) the high initial transaction costs of gathering the data and setting up such products, and (ii) the difficulty of coordinating such supranational insurance products (as insurers require a large and diversified group of countries to keep premiums moderate). The supply of affordable insurance may also be limited by the asymmetric information and moral hazard problems affecting the insurance market in general, accentuated by the fact that the counterparts for insurers are diverse and complex countries. Government demand can also be dampened by certain drawbacks to taking out traditional insurance compared to contingent credit lines. Insurance premiums are typically higher than applicable standby fees under contingent lines, given that premiums are designed to cover the entire eventual non-reimbursable payout (as opposed to contingent lines, which disburse as interest-carrying loans). Another relevant factor mentioned in OVE interviews is the fact that payments for insurance premiums count as current spending (as opposed to debt service for contingent loans) and thus come out of the primary budget, for which many countries have strict deficit targets.

In providing contingent lending for exogenous economic and financial shocks, MDBs have sought to complement both countries' self-insurance efforts (e.g., reserve build-up) and support by the International Monetary Fund. Many authors have observed that the International Monetary Fund (IMF) is better suited for acting as international liquidity lender of last resort because of both its mandate and its large capital base (Cordella and Levy Yeyati 2005; Forbes 2006). As Perry 2009 discussed, MDBs have neither the mandate nor the resources to play that role effectively. However, demand from some constituencies has caused MDBs, including the IDB, to offer liquidity in crisis situations with the rationale of avoiding crisis-triggered retrenchments in social and development gains, recognizing that

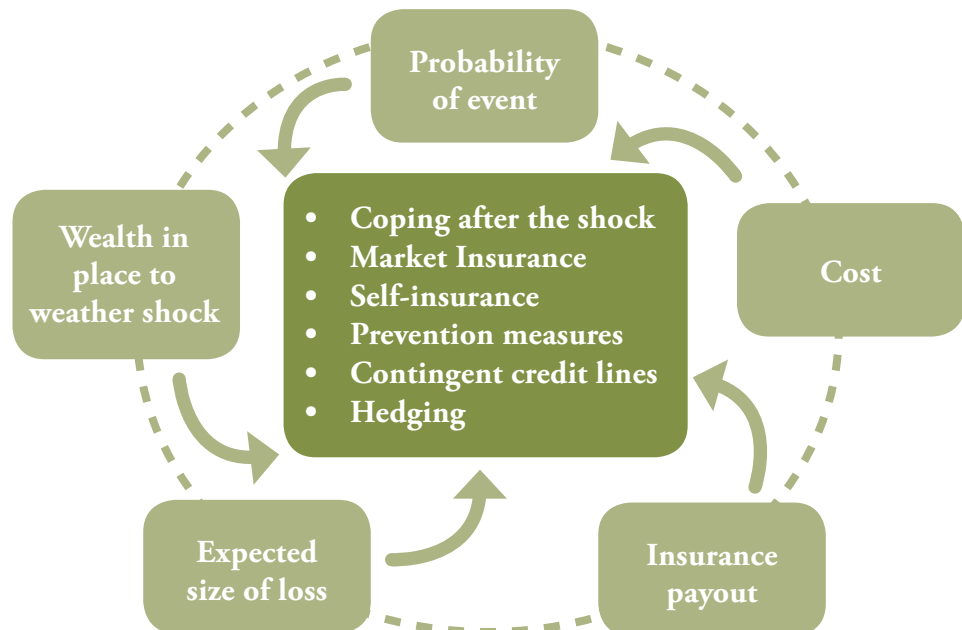
“development banks still have a key role to play in ensuring that long-term programs are preserved so that social progress and development agendas do not get off-track” (AB-2890). An argument sometimes advanced for MDB contingent support is that IMF lending is typically directed at central banks and meant to strictly address balance-of-payment needs, whereas MDB crisis lending is more flexible in that it can respond to a wider set of economic downturns and financial crises, and can finance a government’s countercyclical spending needs directly.⁴ Nevertheless, even within MDBs there is debate about the extent to which contingent and emergency lending for financial and economic shocks should be an ongoing role for such institutions. At the IDB, for example, a 2010 Management proposal (GN-2564-1, not approved) argued for eliminating the emergency lending category upon the IMF’s introduction of a new contingent product, the Flexible Credit Line (Chapter IV.A provides more details on this instrument).

Contingent lending is often referred to as a type of insurance. Given that both contingent lending and insurance require ex-ante payments for protection against uncertain future events, it is reasonable to assume that demand for contingent lending depends on similar factors as demand for insurance. Basically, consumers (governments, in this case) make insurance decisions by weighing five dimensions: (i) the probability that the insured event will occur, (ii) the insurance premium or cost, (iii) the insured amount (or expected insurance payout), (iv) the expected size of the loss should the event occur, and (v) resources available to weather the shock (Kunreuther and Pauly 2006). Countries make decisions about insurance or contingent lending by weighing these five factors for all crisis management options at their disposal (see Table 2.1 and Figure 2.1).

However, MDB contingent lending differs from traditional insurance products in several ways. First, MDBs generally do not price-discriminate among borrowing members. Whereas insurance hinges on determining the appropriate relationship between the probability that

FIGURE 2.1
Demand factors

Source: OVE analysis, based on Perry (2009) and Kunreuther and Pauly (2006).



the insured event will occur and the insurance premium (dimensions i and ii of the previous paragraph), fees for MDBs' contingent products are usually independent of the probability that the insured event will occur in a particular country. Second, MDBs' products often imply less certainty about the automaticity of resources when the shock occurs than traditional insurance products. This is due to certain disbursement conditions for contingent credit lines (such as maintaining an adequate macroeconomic framework or disaster risk management systems) that leave more room for judgment and interpretation than the typically specific provisions of private insurance contracts. Third, the limited drawdown periods of contingent credit lines are at odds with traditional insurance, under which coverage is normally open-ended and continues as long as premiums are paid, the contract is not cancelled, and contract provisions are adhered to. Fourth, insurance payouts are non-reimbursable (i.e., grants), whereas contingent credit line drawdowns are interest-carrying debt (which explains why insurance premiums are comparatively higher). Finally, the supply of affordable and sustainable insurance relies on the pooling of a large number of risks in a highly diversified portfolio, whereas MDBs' risk differentiation options are constrained by their limited number of borrowing member countries, which often have correlated economic cycles. As discussed below, some of these differences pose challenges for the design and uptake of contingent instruments.

From the MDBs' perspective, contingent lending (and generally reserving resources for countercyclical support) has important opportunity costs, especially when resources are constrained. Since funds for additional countercyclical crisis lending have to be built up before crises hit, contingent and ex-post emergency lending generally means lower lending for development during tranquil times. The pricing and maturity of such instruments also affect their cost to MDBs, as well as the risk ratings of borrowers of crisis loans. These costs can be exacerbated by the limited risk diversification options available to regional development banks such as the IDB, because of their smaller number of borrowers with often similar vulnerabilities.

From the countries' perspective, ex-ante contingent financial instruments can provide greater predictability than ex-post assistance, representing a more proactive approach to managing risk. First, contingent borrowing enhances predictability in public finances; in turn, such predictability decreases the need to divert public spending from priority development projects and social spending to fund emergency and remedial expenditures in times of crisis (WB, 2009b). Second, contingent borrowing can reduce the need to raise new domestic debt in an expensive post-event capital market and/or to increase taxes, which may discourage the new private investments that are central to redeveloping the economy (Ghesquiere and Mahul 2007). Third, the prompt availability of funds can help speed up recovery and reduce the poverty impact of shocks. Fourth, establishing contingent arrangements can send signals of stability to the market and thus potentially prevent certain crises from happening or escalating. Overall, both the loss of life and the economic impact of natural hazards and external economic shocks can be reduced by advance planning.

In contrast, the ex-post nature of emergency lending makes it a more unreliable risk management instrument. However, since the financing needs arising from a shock cannot be easily predicted, ex-post financing does allow for more efficient "tailoring" to countries' needs (IMF 2011).



3

3 Contingent Lending at the IDB

The IDB has offered four different contingent lending instruments: the Development Sustainability Line (DSL) for external economic and financial shocks; the Deferred Drawdown Option for policy-based loans (PBL DDO)⁵ for general budget financing needs (including for shock situations); and the Contingent Credit Facility for Natural Disaster Emergencies (CCF) and Contingent Credit Line for Natural Disasters (CCL). Before offering contingent instruments for economic and financial shocks, the IDB focused on ex-post emergency assistance (Annex I traces the evolution from emergency to contingent lending at the IDB).

A. EXTERNAL ECONOMIC AND FINANCIAL SHOCKS

The DSL was established in 2012 to protect funding for pro-poor programs⁶ in countries facing systemic and/or country-specific exogenous shocks. Systemic shocks were defined as episodes during which the EMBI spreads⁷ of at least one-third of the Bank's 26 borrowing member countries exceeded their five-year rolling mean by two standard deviations or more, independent of whether the requesting country itself was facing increased spreads. For country-specific shocks, the loan proposal had to define the specific triggers and threshold values that would determine that an exogenous shock had materialized, to allow the country to draw down under the DSL. The social spending to be protected under the DSL had to be identified at the time of approval, and the loan proposal had to demonstrate how protecting such programs during a crisis would benefit the poor and vulnerable in particular.

Approval and disbursement of DSL operations involved establishing or verifying (i) the systemic or country-specific trigger events, (ii) the status of the protected social programs, and (iii) the prevailing macroeconomic conditions. For a DSL operation to be approved, the loan proposal needed to specify the relevant programs to be protected during the shock, and

the triggers and threshold values for country-specific shocks. Additionally, a positive assessment of the prevailing macroeconomic conditions was required. Until mid-2014, to be eligible for a DSL, countries needed a positive independent macroeconomic assessment, as well as an IMF Article IV issued in the previous six months (or a comfort letter). After July 2014, the macroeconomic requirement was an Independent Assessment of Macroeconomic Conditions (IAMC).⁸ Borrowers could request the disbursement at any time during the three-year drawdown period, provided that one or more of the country-specific trigger events had materialized, the macroeconomic conditions were still assessed positively, and the protected programs remained in place and funded. During the drawdown period, the Bank would monitor at least every six months that the specified protected programs remained funded and that the country continued to have a sustainable macroeconomic framework. Borrowers needed to be notified “in a prompt manner” (AB-2890) if any conditions for disbursement were not met.

Bank guidelines were ambiguous about several aspects, including what qualifies as a country-specific shock, and whether resources would at all times be available and swiftly disbursed in case of need. Bank guidelines (AB-2890) required triggers to be “events that are not anticipated, that are significantly different from any baseline projection for the variable in question and that are expected to produce serious consequences that are nationally systemic in nature affecting economic activity, poverty rates, fiscal balances, the balance of payments, or credit in the financial system.”⁹ However, the document did not attempt to reconcile what “not anticipated” should mean in the context of a contingent credit instrument, which in fact required anticipating specific events and their triggers. Moreover, no additional guidance was provided about just how large a deviation from baseline projections would merit drawdown under the DSL, leaving the door open to potential uncertainty and inconsistency in trigger levels. Another uncertain issue was how the Bank would ascertain, and borrowers know, whether they remained eligible for disbursements during the drawdown period. AB-2890 foresaw that “the Bank and the borrower will maintain a close policy dialogue throughout the drawdown period.” The document did not specify, however, what this close dialogue should consist of in each case, and this left some uncertainty about whether resources would be available and swiftly disbursed in case of need—especially given that deteriorating macroeconomic conditions could jeopardize the required positive macroeconomic assessment.

The DSL was funded with the temporary increased capacity of the Unused Borrowing Capacity created by the IDB-9, and loans were priced considerably higher than regular SG lending. Because of the Bank’s IDB-9 contributions, capital accumulated faster than it was required for regular lending, so the DSL provided a way to avoid having unused capital in the years immediately following the IDB-9 contributions (AB-2890, AB-2791, FN-660-1). The global limit for approvals was set at US\$2 billion per year from 2012 to 2014, and US\$6 billion cumulative.¹⁰ Resource availability was to be reviewed every year as part of the Bank’s Long-Term Financial Planning (LTFP) exercise.¹¹ At the country level, a limit was set of US\$300 million or 2% of GDP

(whichever is less), though other factors such as demand, debt, and fiscal needs were to be taken into consideration when sizing each operation. At least initially, the DSL was designed not to count against countries' regular lending ceilings. Loans under the DSL were priced at 165 basis points (bps) per year above the regular ordinary capital (OC) lending spread. Tenors were capped at six years, with a maximum grace period of three years. A front-end fee of 50 bps was charged, and undisbursed balances incurred a standby fee of 50 bps per year.

Only El Salvador and Ecuador have used the DSL (see Table 3.1). The IDB approved a credit line of up to US\$100 million to the Central Reserve Bank of El Salvador in 2013 (ES-X1007), and one of up to US\$300 million to the Ministry of Finance of Ecuador in 2014 (EC-L1145), the maximum per country that could be made available under the DSL guidelines. While authorities from Jamaica and Panama also expressed interest, no DSL operations materialized.

The DSL objective in El Salvador was to enable the Central Bank to offer short-term liquid resources to financial institutions in case of liquidity shortages, supporting its role as lender of last resort. The DSL was expected to “serve as a first step towards establishing a financial stabilization liquidity fund and as support for the [Central Bank] so it can execute its role as lender of last resort through temporary liquidity supports.”¹² Since at that time the Central Bank had cash reserves of around US\$2.4 billion, the potential impact that a US\$100 million credit line (corresponding to about one percent of deposits at the time¹³) could have in a crisis scenario was questionable. Experts interviewed suggest that the DSL's pricing might have discouraged El Salvador from requesting the full possible amount.

The resources approved under El Salvador's DSL were not used, and the operation was cancelled two years after its approval. Despite the Government's appreciation of the credit line,¹⁴ the fact that the country's IAMC was set to expire in late 2015 meant that the country was no longer eligible to withdraw the DSL resources. To avoid paying standby fees for a product that in practice was no longer available, the Government requested the cancellation of its DSL in December 2015.

The DSL objective in Ecuador was to protect and provide sustainability to the Human Development Bond and pension programs. As required under AB-2890, the loan specified triggers (eligible events) for systemic (EMBI spreads) and non-systemic exogenous shocks (linked to spot prices for Ecuadoran oil, 3-month US\$ LIBOR, volume of Ecuador's oil exports, and debt disbursements). The DSL covered about 13% of the cost of the protected programs during the drawdown period of three years (or 40% of the estimated annual cost).

DSL resources were disbursed shortly after Board approval, thus resembling more an emergency loan than a contingent credit line. In a 6-month time span, the operation entered the pipeline (August 2014), was approved by the Board of Executive Directors

(December 2014), and was fully disbursed (February 2015). Between the initial pipeline date and the operation's approval, the spot price of crude oil plummeted from about US\$100 to less than US\$50, which led to the activation of several of the DSL's triggers for country-specific exogenous shocks before approval. This issue sparked discussions at the Board regarding both the selection of triggers and the window of time in which the triggers could be considered activated, as the DSL was designed with the expectation that each contingent credit line would be approved before an exogenous shock hit.

B. GENERAL FINANCING NEEDS (INCLUDING FOR SHOCKS)

The PBL DDO modality, introduced in 2012 (AB-2890), allows countries to have access to previously approved PBL resources in amounts, and at the time, that meet their needs most effectively. Thus OC-eligible borrowers can use PBLs in a contingent way. While the use of PBL DDOs is not restricted to—or contingent on—the occurrence of a shock, countries have *de facto* used all types of PBLs as an important source for liquidity in crisis times (RE-485-6). The practice of deferring drawdowns under PBLs (exercised by Uruguay since 2008) was institutionalized with the creation of the DDO modality in 2012. If a country chooses the DDO option for a PBL, it can request disbursement at any time during the three-year drawdown period, which can be renewed once for another three years. Since the expiration of the DSL at the end of 2015, the PBL DDO is the IDB's only contingent instrument that can be used for financing needs emanating from external financial and economic shocks.

PBL DDOs have the same approval and disbursement conditions as regular PBLs. This includes definition of (for approval) and satisfactory compliance with (for disbursements) the agreed policy and institutional conditions, as well as a positive IAMC. During the drawdown period, monitoring of all conditions takes place at least annually, and—as under the DSL—a “close policy dialogue” (AB-2890) is foreseen to ensure that countries always know whether they remain eligible for disbursement. Unlike under the DSL, AB-2890 specifies that countries are deemed eligible for disbursement unless the IDB has previously notified them that any conditions are no longer met.

As for all PBLs, financial conditions are determined by the rules of the Flexible Financing Facility (CF-173). This includes pricing (variable OC lending spread), tenor (maximum 20 years) and grace period. The standby fee of 50 (25 before end-2015¹⁵) bps per year is the same as for undisbursed balances under regular PBLs. The only additional cost for PBL DDO is an up-front fee of 50 bps. Since PBL DDOs are part of regular SG lending, amounts approved under this modality count against each country's lending envelope (Annex II, Table II.2, compares DSL and PBL DDO financial conditions).

Only Uruguay and Peru have used the PBL DDO (see Table 3.1). To date, none of the PBL DDO operations has disbursed. Since establishing the DDO modality in 2012, the Bank has approved three loans for Uruguay under the Programmatic PBL “Strategic International Positioning Program” (UR-L1076, UR-L1097, UR-L1106) for a total of

US\$550 million. Peru is a more recent user of the DDO modality: it first used it in April 2015, with the second loan of the programmatic PBL “Results Management Program for Social Inclusion” (PE-L1154, US\$300 million). A few months later, the Bank also structured the first loan of the programmatic PBL program “Improving Management for Universal Health Coverage” (PE-L1169, US\$300 million) as a DDO.

Uruguay has been a pioneer in using contingent PBLs and was a major proponent of creating the DDO modality at the IDB. Since the late 2000s, Uruguay has requested disbursements of approved PBLs only in cases of liquidity shortage and when alternative funding sources became more expensive. For example, despite early compliance with the disbursement conditions of two PBLs approved in 2005 and 2007 (UR-L1003 and UR-L1007), the Government opted not to draw on the proceeds until financing terms deteriorated in December 2008 and January 2009 after the collapse of Lehman Brothers. Since the IDB’s creation of the PBL DDO, all PBLs approved for Uruguay have been in the DDO format. Interestingly, many of the most substantive policy conditions in those loans had already been supported by a previous set of investment loans that helped the country improve its international positioning. In other words, the PBL DDO did not catalyze reforms or deliver technical additionality, but mostly facilitated a framework for the organization of initiatives that were already under way (RE-484-1).

Peru is a more recent user, requesting its first PBL DDO in 2015. The Government envisaged small financing requirements in the very short term, but it anticipated some deterioration in the nonfinancial public sector’s fiscal performance after 2017 that, together with a bunching of debt maturities, could lead to greater financing requirements. The use of PBL DDOs was seen as consistent with that contingency (see PE-L1054).

C. NATURAL DISASTERS

The first contingent lending instrument created by the IDB for natural disasters was the CCF, approved in 2009 to cover fiscal gaps arising immediately after a major natural disaster. The CCF is the only IDB contingent instrument that can be used by both OC and Fund for Special Operations (FSO) borrowers. CCF operations are treated as investment loans, with five main modifications. First, for approval and disbursement, countries are required to have a Country Integrated Disaster Risk Management Program (IDRM) conforming to Bank standards¹⁶. Second, the loan proposal document has to define which types of natural disasters are covered, and establish the parametric triggers¹⁷ (and their source) to be used to verify that a natural disaster of the specified type and intensity has occurred. Third, to allow for quick disbursement when the need arises, the country’s own procurement rules apply (rather than those of the IDB). Fourth, unlike for investment loans and PBLs, the approval and signature of a CCF operation does not immediately commit new Bank resources (see next paragraph for more details). And finally, the speed of disbursement under CCF operations is not subject to the IAMC requirement (AB-2990).

CCF operations can redirect undisbursed loan balances from previously approved operations¹⁸, and/or access new resources. If loan balances from previously approved loans are used, the loan proposal document has to establish a list—which is regularly updated during the drawdown period—of operations whose unused loan amounts would be accessed under the CCF. If new resources are chosen, no amounts are committed upon approval of a CCF operation. This means that the availability of new funds for disbursement generally depends on whether there is still space in the country's lending envelope at the time the country requests the resources.

There is a five-year drawdown period (renewable once for another five years), and several conditions have to be met for countries to be eligible for disbursement. For disbursement, the following items need to be in place: (i) parametric trigger data verification must confirm the occurrence of a disaster event of the agreed type, location, and intensity; (ii) the request must have been submitted within 90 days after the onset of the disaster event; and (iii) the IDRMM must be in place in accordance with Bank standards. Annual monitoring is conducted to assess whether the IDRMM continues to be executed satisfactorily. If deficiencies are found, countries are formally notified of the remediation actions needed to restore eligibility.

CCF operations can have tenors of up to 25 years, with a maximum grace period of 5 years.¹⁹ The prevailing OC lending spread applies to the loan, and there is no front-end fee. No additional standby fees are charged for the CCF on redirected loan balances. If new resources are used, the IDB's regular credit fee is applied retroactively upon drawdown on the disbursed amount, calculated from signature to disbursement.

CCF loans count against each country's SG lending envelope. In 2012 (AB-2890), the country limit for CCF operations was raised from US\$100 million (or 1% of GDP, whichever was less) to US\$300 million (or 2% of GDP, whichever is less), and the global limit of US\$600 million was eliminated. These limits apply regardless of whether funds are new or reallocated from previous projects. The amount to be disbursed is a function of the event's intensity and the population affected. Only expenditures that are caused directly and indirectly by the event, and are incurred and paid within 180 days following the onset of the disaster, are eligible for financing.

Seven countries have taken advantage of the CCF since its establishment in 2009 (see Table 3.1). No CCF operations have disbursed so far. Most countries have used the CCF by redirecting undisbursed loan balances from previously approved investment operations, with only Peru preferring new resources. The first CCF request was from the Dominican Republic in 2009, to assist with the implementation of a natural disaster risk financing strategy for earthquakes or hurricanes. In 2011, Honduras became the first FSO borrower under the CCF. In 2012, Ecuador,²⁰ Panama, and Costa Rica also requested CCF loans to cover earthquakes and floods (and hurricanes, for Costa Rica). Finally, in late 2013, CCFs were also approved for Peru (earthquakes) and Nicaragua (earthquakes and hurricanes).

In 2012 (AB-2890), the CCL was created to cover a wider range of natural disaster events than the CCF. Unlike the CCF, any natural disaster that results in the declaration of a state of emergency by a competent (national, state or municipal) authority can lead to disbursements of a CCL, as long as the other disbursement conditions are met. The objective of the CCL is similar to the CCF's: to help countries cover urgent financing needs arising immediately after a disaster.

The CCL was funded by the resources freed up when the Bank's UBC buffer was reduced from US\$4 billion to US\$2 billion in 2012 (FN-668-1). The size of the CCL was initially set at US\$2 billion for 2012-2014, and at the end of that period its limits would be reevaluated. Additionally, a country limit of US\$100 million or 1% of GDP (whichever is smaller) applies. CCL loans do not count against the Bank's 30% PBL limit, nor against regular country lending envelopes.²¹

TABLE 3.1: UPTAKE OF CONTINGENT LENDING CREDIT LINES AND FACILITIES, 2009-2015

	Facilities / credit line	Country	Operation name	Operation number	Year	Approved amount (US\$ million)
Economic crises	DSL	El Salvador	Contingent Credit Line for Sustainable Development	ES-X1007	2013	100
		Ecuador		EC-L1145	2014	300
General financing needs	PBL DDO	Uruguay	Strategic International Positioning	UR-L1076; UR-L1097; UR-L1106	2013 2014 2015	550.7
		Peru	Improving Management for Universal Health Coverage Program	PE-L1169	2015	300
		Peru	Results Management Program For Social Inclusion	PE-L1154	2015	300
Natural disasters	CCF	Dominican Republic ^a	Contingent Loan for Natural Disaster Emergencies	DR-X1003	2009	100
		Honduras		HO-X1016	2011	100
		Ecuador		EC-X1008	2012	300 ^b
		EC-X1014		2014		
	CCL	Panama		PN-X1007	2012	100
		Costa Rica ^c		CR-X1010	2012	200
		Peru		PE-X1006	2013	300
		Nicaragua		NI-X1007	2013	186
		-	-	-	-	-

Source: OVE, based on IDB data warehouse.

^a In October 2015, the Dominican Republic requested the renewal of its CCF for another 5 years.

^b In 2012, Ecuador got approval for a \$100 million CCF operation, which it replaced with a US\$300 million CCF operation in 2014.

^c Costa Rica's CCF has not been ratified and therefore never became effective.

Loans under the CCL are treated as PBL DDOs, and thus follow the PBL guidelines (CS-3633, CS-3363-1) for all operational, fiduciary, and procurement purposes. Approval requirements include (i) the existence of an IDRM, and (ii) a positive macroeconomic assessment (now, a valid IAMC). During the three-year drawdown period, compliance with these conditions is monitored at least annually, with a “close policy dialogue” (AB-2890) to provide certainty to countries about their continued eligibility for disbursement. Unless the IDB informs a country that one or more eligibility conditions are no longer met, the country may request drawdown of the full approved amount upon the declaration of a state of emergency following a natural disaster.

Financial conditions for the CCL differ from PBLs in that the full OC lending spread is charged as standby fee on undisbursed balances. Moreover, a maximum tenor of 14 years (with a grace period of 3 years) and a front-end fee of 50 bps apply.

The CCL has not been used. Interviewees cited the instrument’s high standby fee as the main reason for the lack of demand. Other factors mentioned included the possibility that the availability of resources would be less than automatic, given the requirement of a valid IAMC.

D. FINANCIAL CONSIDERATIONS FOR THE IDB’S CONTINGENT LENDING INSTRUMENTS

In contrast to the PBL DDO and CCF, resources for the DSL and CCL were additional to regular IDB lending. The main limit to each instrument was the IDB’s borrowing capacity, which was the binding constraint on IDB lending at the time. AB-2890 established that for the DSL, the available resources were to be revisited annually in the context of the LTFP exercises. The CCL’s limits were to be reviewed in 2014.

In the years following 2012, the IDB’s approach to determining its lending capacity and capital adequacy evolved to reflect changes made by rating agencies in 2012 to the methodologies they used to evaluate MDB credit risk. The IDB’s capital adequacy and the need to maintain its AAA rating became the binding constraint²² to its lending. IDB approved a new Capital Adequacy Policy Mandate (AB-2994) in October 2014, followed by the Regulations Governing the Implementation of the Capital Adequacy Policy (AB-2996) in December 2014, and the Amendment and Restatement of the Income Management Model (AB-3044) in August 2015. While developing these policies between 2012 and 2014, IDB monitored its capital adequacy in line with the rating agencies’ new rules.

The limits and resource availability for the DSL and CCL were never formally revisited. While the DSL and CCL continued to exist, from 2014 the Bank's increasingly constrained lending envelope resulted in uncertainty about whether the instruments would in fact be available outside of any (otherwise eligible) country's regular lending envelope. The change in the Bank's financial management methods meant that the previously available buffer resources were increasingly consumed by the Bank's regular OC lending. Reflecting the fact that any approvals under the DSL and CCL counted against the Bank's capital and thus its risk absorption capacity, the 2015 Transitional LTFP (FN-692-2) showed amounts approved under the DSL/CCL as part of the regular OC lending envelope. The new Income Management Model (AB-3044), adopted in 2015, formalized the IDB's approach to contingent lending resources by stating that amounts approved under these products formed part of the annual SG lending envelope unless the Bank's Capital Coverage Ratio was in the Buffer Zone (that is, capital buffer was available). This approach was also followed in the 2016 LTFP (FN-700-4, paragraph 6.3), which subsumed any resources to be allocated for contingent lending instruments under the SG lending envelope.²³

From the standpoint of exposure and risk capital, undrawn amounts under contingent instruments are treated the same way as any undisbursed loan balances.²⁴ Under the IDB's Capital Adequacy rules, 40% of all approved undisbursed balances are included in each borrower's credit exposure (AB-2996). This implies that approval of a contingent line reduces the IDB's capacity for regular lending to that country by 40% of the approved amount. When buffer resources are used for contingent instruments, the amount by which the available buffer is reduced by each contingent loan approval depends on the risk rating of the country for which the loan was approved, as well as other factors such as the approval's impacts on portfolio and risk concentration. The credit or standby fees charged on undrawn balances, and the lending spread charged on disbursed amounts, repay the amount of capital that needs to be set aside for exposure under contingent lines. Whereas the amount of capital set aside varies on the basis of risk and portfolio concentration factors, the pricing of the IDB's contingent instruments—like that of SG lending²⁵ in general—is uniform across all countries.



4 Contingent Lending at other MDBs and the IMF

A. WORLD BANK, ASIAN DEVELOPMENT BANK, AND DEVELOPMENT BANK OF LATIN AMERICA

1. Economic and financial shocks

Only the Asian Development Bank (ADB) and Development Bank of Latin America (CAF) offer dedicated crisis-specific contingent lending instruments for financial and economic shocks (similar to the IDB's DSL). The ADB's main contingent lending instrument for financial or economic shocks is the Precautionary Financing Option (PFO) under its Countercyclical Support Facility (CSF), and CAF provides its Contingent Credit Line for Financial Emergency for financial shocks. (Table 4.1 provides an overview of financial terms and limits of the ADB's CSF PDO and the CAF's Contingent Credit Line for Financial Emergency, compared to the IDB's DSL.)

The ADB's CSF aims at supporting countercyclical fiscal stimulus in crisis times. Created in 2009 with an allocation of US\$3 billion from ordinary capital resources, the CSF resulted from a G20 request to the IMF and MDBs to provide an additional US\$850 billion during the 2008-2009 global financial crisis.²⁶ The CSF was originally created for 2009-2010 and was mainstreamed as a permanent lending instrument in 2011. As under the ADB's other main crisis lending facility, the Special Policy-Based Lending²⁷ instrument, access to the CSF is restricted to ADB member countries that do not qualify exclusively for its concessional window, the Asian Development Fund (ADF).²⁸ The PFO was added to the CSF in 2011 on the recommendation of the ADB's independent evaluation department. Like the IDB's PBL DDO, the PFO is simply an option for countries not to request immediate disbursement after approval of a CSF loan. The CSF PFO formalized the contingent option under the CSF; however, this was not the first time the ADB had allowed for contingent use of its funds, as postponing drawdown for a certain amount of

time is, in general, possible for any ADB PBL operation.²⁹ Since 2011, only Indonesia has made use of this modality in its US\$500 million Precautionary Financing Facility (PFF), approved in June 2012 and disbursed in December 2015 (see Box 4.1).

Box 4.1. Indonesia's Precautionary Financing Facility (PFF)

Indonesia's PFF is a US\$500 million CSF PFO operation, approved in 2012, that forms part of a US\$5 billion coordinated (ADB, World Bank, Australia, and Japan) assistance package aimed at supporting Indonesia's financing needs in light of the turbulence in global financial markets. The availability of contingent funds was designed to send a strong signal to revive market confidence after Indonesia faced volatility in 2011.

The PFF was designed as an insurance device to fall back on only after exhausting all other alternatives for meeting the Government's financing targets as established in its financing plan. Disbursement was contingent on (i) a crisis having materialized in the form of bond yields exceeding a certain level (without specifying exactly what level), and (ii) market stabilization operations, alternative debt financing sources, and any surplus being unable to fulfill the financing need.

Eligibility for drawdown was assessed quarterly, reviewing (i) the Government's continued sound macroeconomic management (including measures aimed at ensuring financial market confidence), (ii) Indonesia's countercyclical programs, (iii) implementation of the financing plan, and (iv) any financing shortfall.

The operation was approved for a term of five years (including a three-year grace period), and the initial 18-month drawdown period was extended three times for an additional 24 months. Shortly before fully disbursing in December 2015, the PFF was modified to link repayment terms to disbursement (as opposed to commitment, as was the case initially).

For approval and disbursement of a CSF operation, as for any PBL in the ADB, a stable macroeconomic framework is required.³⁰ For CSF operations, such macroeconomic assessments differentiate between exogenous and endogenous factors when determining eligibility, with emphasis being placed on whether countries' macroeconomic and fiscal management is generally sound.³¹ Moreover, given that the CSF is designed to support countercyclical fiscal stimulus (rather than general balance-of-payments support), governments need to show commitment to implementing specified countercyclical expenditure programs, such as investments in infrastructure or the social safety net. Unlike other PBLs, CSF PFO operations do not require a policy matrix at the microeconomic level. Eligibility for drawdown under the PFO is contingent on a crisis scenario's materializing, and can be conditioned on market developments and the borrower's access to finance. However, no specific guidance on what constitutes crisis events—for example, in the form of quantitative triggers—is set at the instrument level:³² disbursement conditions are determined individually for each operation.

TABLE 4.1. TERMS AND LIMITS OF IDB, ADB, AND CAF CONTINGENT INSTRUMENTS
FOR FINANCIAL AND ECONOMIC SHOCKS

Category	DSL (IDB)	CSF PFO (ADB)	Contingent Credit Line for Fin. Emergency (CAF)
Global limit	US\$2bn/year cumulative approvals from 2012-2014; US\$6bn total. ^a	No set global limit. Approval subject to ADB's risk-taking capacity, which is constrained by a minimum 25% long-term equity-to-loan ratio.	US\$2bn (including contingent lines for natural disasters)
Country limit	US\$300 million or 2% of GDP, whichever is smaller	US\$500 million, but determined case-by-case, based on need and ADB's risk-bearing capacity ^b	US\$500 million (US\$100m minimum)
Counts against regular country lending envelope?	No	No ^c	Yes
Max. Tenor	6 years	5-8 years ^d	7 years
Grace period	3 years	3 years	18 months
Front end fee	50 bps	none	45 bps
Standby fee	50 bps/year ^e	75 bps/year ^f	35 bps/year
Loan spread	Variable OC lending spread ^g plus 165 bps/ year	200 bps/year	175 bps/year (same as regular CAF loans of similar tenors ^h)
Renewal fee	none	none	none
Cost base	3-month LIBOR, plus/ minus IDB funding margin	6-month LIBOR plus/ minus ADB funding margin for CSF resources specifically	6-month LIBOR plus/ minus CAF funding margin
Drawdown period	3 years	Case-by-case, can be extended if needed	One year, renewable as many times as country requests and CAF approves

Source: OVE interviews and various IDB, ADB, and CAF documents.

^a The de facto availability of funds changed subsequently because of changes in the IDB's risk management practices. See Chapter III.D for more details.

^b The minimum long-term equity-to-loan ratio of 25% is expected to be preserved (Review of ADB's Policy Based Lending, June 2011).

^c Also does not count against ADB's PBL ceiling of 20% of total lending on a 3-year moving average basis.

^d Usually, repayment terms are linked to commitment. However, it is possible – as in all ADB operations – to link repayment terms to disbursement instead. This last option was exercised in a 2015 modification to Indonesia's PFF.

^e Changed to 75 bps by FN-700-4, effective January 2016; however, the DSL had ceased to exist by then.

^f Commitment fees on regular undisbursed ADB balances are 15 bps/year.

^g Currently, the OC lending spread is 115 bps.

^h CAF lending spread increases with maturity.

The CAF's Contingent Credit Line for Financial Emergency (like its contingent line for natural disasters) is usually prepared before a shock hits, though the loan contract is only signed once a shock effectively occurs. This implies that, unlike the IDB, CAF typically does not commit resources (and thus no standby or commitment fees apply) before the financing need actually arises. In this sense, the CAF's contingent credit lines are a hybrid

between ex-ante contingent and ex-post emergency lending. While contingent lending forms part of the CAF's regular SG lending program, contingent credit lines do not count against countries' lending allocations.

Contingent liquidity lines for financial and economic shocks are available only to CAF member countries that are frequent debt issuers in international capital markets; the liquidity lines serve as a fallback option for situations in which access to market financing deteriorates. While the contingent liquidity lines are primarily aimed at responding to exogenous shocks, the CAF can—upon the recommendation of an internal committee—also contemplate disbursements for crises caused by endogenous factors. Countries can draw on their contingent liquidity line if the terms of accessing market financing deteriorate markedly, and if a CAF-internal committee confirms such sufficiently worsened conditions. No specific and quantitative thresholds for bond yields or other relevant variables are needed. Several countries have used the CAF's contingent liquidity lines;³³ however, thus far only Uruguay has requested disbursement (2008/2009).

2. General financing needs (including for shocks)

Only the World Bank (WB), with its deferred drawdown option (DDO) for its Development Policy Financing (DPF) operations, offers a product similar to the IDB's PBL DDO. Neither the CAF nor the ADB has established an explicit contingent modality for their PBLs. However, borrowers can informally choose to delay requesting disbursement for a certain amount of time during the period that funds are available.

The WB formally introduced contingent lending in 2001 (World Bank 2001) through a new instrument variant—DPF with a DDO.³⁴ Recognizing middle-income countries' need for financing instruments to manage contingent risks and budget needs, the DPF DDO gives IBRD and IBRD/IDA-blend borrowers the option of deferring disbursement under DPF operations. As under the IDB's PBL DDO, proceeds under the DPF DDO can be drawn at any time during the three-year drawdown period,³⁵ including for economic and financial shock situations. Disbursements are subject to the WB's verifying the adequacy of the country's (i) implementation of the agreed policy program, and (ii) macroeconomic policy framework.³⁶ It is important to note that the WB's macroeconomic assessment focuses on the macroeconomic *framework* rather than more generally on macroeconomic *conditions*—that is, it makes a clear distinction between endogenous and exogenous factors.

In response to the low initial uptake of the DPF DDO,³⁷ the WB reformed the instrument in 2008 to convey greater certainty concerning the prompt availability of funds and to change pricing.³⁸ Procedural changes in 2008 shifted the responsibility for maintaining and promptly communicating continued eligibility for drawdowns explicitly to the WB, making clear that borrowers have immediate access to funds upon request unless the WB has previously notified them of any loss of eligibility. In the years since 2008, the DPF DDO has been more used (see Annex IV, Table IV.4, for the global portfolio).

Four countries in Latin America and the Caribbean (LAC) have used the DPF DDO, with Peru and Uruguay being the most frequent users. Since 2003, the WB has approved 17 DDOs (see Annex IV, Table IV.4). In LAC, Chile, Peru, Costa Rica, and Uruguay have used the instrument. Four of these loans are active: two for Uruguay (approved in 2011 and 2012, each for \$260 million) and two for Peru (approved in 2016, each for \$1.25 billion). The seven closed DPF DDOs in LAC have all disbursed, but none of the four currently active operations has been drawn down to date.

The financial terms of the WB's DPF DDO compare favorably to those of the IDB's PBL DDO, especially after the IDB's recent increase in standby fees and loan charges (see Table 4.2).

TABLE 4.2. TERMS AND LIMITS OF THE IDB'S PBL DDO vs. THE WB'S DPF DDO

Category	PBL DDO (IDB)	DPF DDO (WB)
Global limit	Counts against the 30% PBL cap of total Bank lending over a four-year period.	None (but implicit tradition of 25% of total lending)
Country limit	None	None
Counts against regular country lending envelope?	Yes	N/A ^a
Max. Tenor	20 years	35 years (final maturity) ^b
Grace period	Case by case	Case by case
Front end fee	50 bps	25 bps
Standby fee	50 bps (25 before end-2015)	50 bps/year
Loan spread	Prevailing variable OC lending spread (currently 115 bps/year)	50 bps/year, plus a 10-50 bps maturity premium for tenors exceeding 8 years ^c
Renewal fee	None	None
Cost base	3-month LIBOR, plus/minus IDB funding margin	Fixed pricing: projected WB funding cost, plus a market risk premium if applicable Variable pricing: 6-month LIBOR plus/minus WB funding margin
Drawdown period	3 years, renewable once	3 years, renewable once

Source: OVE interviews and various IDB and WB documents.

^a There is no country lending envelope for IBRD countries; however, DPF DDOs count against the country exposure limits.

^b Maximum weighted average maturity for IBRD flexible loans is 20 years.

^c This is the same as for regular DPF loans.

3. Natural disasters

The CAF and the WB also offer contingent instruments for natural disasters. In contrast, the ADB has so far focused on ex-post emergency loans.

The CAF's natural disaster risk management product is the Contingent Credit Line for Natural Disasters (CCL). Created in 2012, this instrument is designed to provide expedited financial support for the reconstruction of damaged infrastructure following natural disasters such as floods, landslides, fires, and earthquakes. To be granted a contingent loan for emergency response, a country must have declared a state of emergency, but no parametric verification of the disaster is necessary. CAF does not require the country to have integrated disaster risk management frameworks or preparedness measures in place to be eligible for the CCL. Several countries have made use of this instrument so far (see Annex VI, Table VI.5).

The WB offers the DPF Catastrophe (CAT) DDO, a DPF variant specifically designed for natural disasters. Created in 2008, the CAT DDO allows IBRD and IBRD/IDA blend borrowers to access loans for immediate liquidity needs in the aftermath of natural disasters.³⁹ Eligibility for drawdown under a CAT DDO is triggered by a declaration of an emergency by a competent authority in the face of an actual or impending natural disaster event. Unlike for the DFP DDO, for the CAT DDO the WB does not monitor the macroeconomic framework or require a positive assessment after approval. As under the IDB's CCF and CCL, the borrower is required to have and maintain a natural disaster risk management program to qualify for and draw down a CAT DDO. CAT DDOs have been popular among LAC countries, eight having been approved for five LAC countries since 2008 (see Box 4.3 and Annex IV, Table IV.5).

The CAT DDO's pricing and maturity are considerably more attractive to borrowers than those of the IDB's and CAF's CCL products. Table 4.3 summarizes the financial terms and limits of the World Bank's CAT DDO⁴⁰ and the CAF's CCL compared to the IDB's CCL.

In addition to the CAT DDO, the WB allows contingent components under regular investment project finance (IPF) operations to deal with emergencies.⁴¹ In allowing for redirection of undisbursed balances under investment projects, the contingent IPF resembles IDB's CCF, with the main difference being that the WB requires the ex-ante identification of specific contingent components as part of each individual project's approval (in contrast to the CCF's ex-post listing of previously approved projects). Setting up contingent IPF components has been an option open to both IBRD and IDA countries since 2007 (World Bank 2007). In 2009 (World Bank 2009) the WB clarified that contingent components were designed to be disbursed only when an emergency⁴² had occurred or was about to occur, and that a disbursement condition for the contingent component needed to define the circumstances that would trigger disbursement.⁴³ It also clarified that contingent components could receive an ex-ante committed allocation ranging from zero to full funding. When triggered, contingent component funds can be disbursed against a pre-specified list of domestic and imported goods required for the country's emergency recovery. Interestingly, a recent IPF for Uruguay was set up as 100% contingent (see Box 4.2).

The Immediate Response Mechanism (IRM) offers IDA countries additional flexibility for redirecting funds from IPF operations in case of an emergency. Introduced in 2011 (World Bank 2011), the IRM was set up as part of the IDA16 funding cycle, and further clarified the rules for the use of contingent IPF in IDA countries. The IRM is not a dedicated funding

source,⁴⁴ and its use is purely voluntary. The main feature of the IRM is to allow for a rapid and more flexible restructuring of IPF operations that include an IRM component, with the restructuring being delegated to WB Management. The overall country cap on IRM components is \$5 million or 5% of the aggregate undisbursed balances in the country's investment portfolio, whichever is larger. Among IDB borrowing member countries, Haiti, Honduras, and Nicaragua have used the IRM option in IPF projects (see Box 4.3 and Annex IV, Table IV.7).

TABLE 4.3. TERMS AND LIMITS OF CCL (IDB), CAT DDO (WB), AND CCL (CAF)

Category	CCL (IDB)	CAT DDO (WB)	CCL (CAF)
Global limit	Resources released from reducing the UBC buffer to US\$2 bn in 2012: US\$2 bn during 2012-2014 ^a	None	US\$2 bn (including contingent lines for financial shocks)
Country limit	\$100 million or 1% of a country's GDP, whichever is less.	Maximum size of 0.25% of GDP or the equivalent of US\$500 million, whichever is less. Exceptions can be made for small states.	US\$50 million
Counts against regular country lending envelope?	No	N/A ^b	Yes
Max. Tenor	14 years	35 years (final maturity) ^c	12 years
Grace period	3 years	3 years	2 years
Front end fee	50 bps	50 bps	65 bps
Standby fee	Prevailing variable OC lending spread (currently, 115 bps/year)	None	35 bps/year
Loan spread	Prevailing variable OC lending spread (currently 115 bps/year)	50 bps/year, plus a 10-50 bps maturity premium for tenors exceeding 8 years ^d	195 bps/year (same as regular CAF loans of similar tenors ^e)
Renewal fee	N/A	25 bps	none
Cost base	3-month LIBOR, plus/minus IDB funding margin	Fixed pricing: projected WB funding cost, plus a market risk premium if applicable Variable pricing: 6-month LIBOR plus/minus WB funding margin	6-month LIBOR plus/minus CAF funding margin
Drawdown period	3 years	3 years, renewable up to 4 times (up to a total of 15 years) ^f	One year, renewable as many times as country requests and CAF approves

Source: OVE interviews and various IDB, WB, and CAF documents.

^a The de facto availability of funds changed subsequently because of changes in the IDB's risk management practices. See Chapter III.D for more details.

^b There is no country lending envelope for IBRD countries; however, CAT DDOs count against the country exposure limits.

^c Maximum weighted average maturity for IBRD flexible loans is 20 years.

^d This is the same as for regular DPF loans.

^e CAF lending spread increases with maturity.

^f Renewal authority is delegated to WB Management. The CAT DDO also has a revolving feature under which the borrower could draw down any funds already disbursed and repaid early; however, this feature has not been used.

Box 4.2. Novel variant of contingent IPF: The case of Uruguay

Uruguay's reliance on hydropower production, which in recent years of good rainfall has accounted for around 80% of total electricity supply, exposes the country to the significant risks of having to bear the higher costs of thermal power generation and/or electricity imports in drought years. The Government stepped up its efforts to manage these risks through the establishment of the *Fondo de Estabilización de Energía* (FEE) in 2010. The FEE serves as a buffer mechanism, accumulating funds in good years and transferring funds to the power utility in bad years.

To ensure that the FEE would have access to additional funds in case of a serious drought, the government sought, and in December 2014 the WB approved, an IPF operation of US\$200 million, with 100% of project funds allocated to a contingent component.^a Disbursement is set to be triggered upon the Government's request when certain hydropower indicators are met (actual quarterly hydraulic generation is 90% or less of the expected quarterly hydraulic generation, and the event has been caused by a drought as evidenced by a formal declaration), and only if FEE funds fall below a certain level. In parallel to project approval, the WB Executive Directors approved a waiver for the project to deviate from regular IBRD loan pricing terms, resulting in this IPF's terms matching those of the DPF DDO (50 bps/year commitment fee, 25 bps front-end fee). This operation complements Uruguay's weather hedge described in Box 4.4.

It is significant that, while the operation provides IPF funds—funds whose use is clearly tied to a particular purpose—in many respects it more closely resembles DPF. In particular, because the funds serve to provide contingent capitalization for the FEE, they are not associated with any specific investment activities and consequently do not have specific procurement requirements or trigger any safeguard policies. Finally, although the Uruguay operation constituted an important precedent now open to replication elsewhere, it is noteworthy that its activation was enabled by a waiver rather than a policy change, and in that regard it has not yet been institutionalized as a new instrument open to routine use. As of February 2016, resources have not been drawn.

Source: Interviews, WB website, and various WB documents.

^a The setup is an SG loan to the National Development Corporation, which subsequently transfers the funds to FEE if their drawdown is triggered. Among the requirements associated with it (in the form of covenants in the Loan Agreement) are measures to ensure sound governance of the FEE.

4. Other risk mitigation tools for natural disasters and other weather-related events

Beyond assuming contingent natural disaster risks on its own balance sheet via contingent lending, the WB has also taken a broader role in facilitating countries' access to market-based risk management tools, including insurance risk pools, weather hedges, and catastrophe bonds. While a comprehensive account of this broader role is beyond the scope of this review, three LAC examples provide useful illustrations of each product.

An example of risk pooling is the Caribbean Catastrophic Risk Insurance Fund (CCRIF)⁴⁵ established by the WB in 2007 (see Box 4.4).

Box 4.3. LAC uptake of the WB's contingent instruments for natural disasters

DPF CAT-DDO

Central America, Colombia, and Peru are the most frequent users of WB CAT DDOs. The WB has had 12 CAT-DDO DPF operations (see Annex IV, Table IV.5). LAC users are Costa Rica, Colombia (2), Guatemala, Peru (2), El Salvador, and Panama. Four of the 12 operations have closed after disbursement following a government's declaration of a state of emergency. The remaining eight operations remain active, and, according to CAT DDO guidelines, funds can be disbursed only upon the declaration of an emergency.

Contingent IPF

In 2014, the WB approved a novel variant of contingent IPF in Uruguay (see Box 4.1); there is no other LAC user. For global use, see Annex IV, Table IV.6.

IRM

Haiti, Honduras, and Nicaragua are avid users of IRM contingent components in IPF operations. The WB has approved 17 operations that include the IRM contingent component (Annex IV, Table IV.), of which 15 are in Haiti, Honduras, and Nicaragua.

Source: OVE review of the WB's portfolio.

The WB introduced index-based weather derivatives in 2008 as part of a comprehensive strategy to reduce the impact of drought in developing countries. The WB intermediates the risk of weather-based catastrophes by entering into mirroring transactions with the client country and a financial market counterpart (typically reinsurance companies). By nature an insurance product, this product requires the payment of premiums and covers risks of very low probability but high severity, such as severe droughts. Uruguay took the largest-ever weather derivative in 2013 (see Box 4.5).

In addition to intermediating between reinsurance providers and countries, the WB has also tapped international bond investors for natural disaster risk coverage. The now institutionalized “Multicat” program, introduced in 2009, is a platform the WB created to facilitate client countries' issue of CAT bonds.⁴⁶ In exchange for paying a higher coupon than for regular bonds, the issuing country is able to retain part or all of the bond principal to fund relief and reconstruction if a pre-specified disaster event occurs.⁴⁷ Catastrophe bonds are in essence an insurance product, with the coupons corresponding to premium payments, and the insurance payout being advanced (but having to be repaid if no disaster occurs). Despite the high risk for investors, these bonds can be attractive since their risks are uncorrelated with those of most other investment portfolios. The WB Treasury acts as arranger of countries' bonds, helps the client governments formulate their disaster risk

management policy, offers an off-the-shelf documentation platform to simplify the bond issuance process, assists with the issuance strategy, and selects service providers for the bond issue. The leveraging effect that the WB obtains from the Multicat program is very large: The WB bears only the administrative cost associated with advising clients and arranging bond issues, in return for very significant coverage of client country natural disaster risks. Mexico has issued CAT bonds twice, in 2009 and 2012 (see Box 4.6).

Box 4.4. The Caribbean Catastrophe Risk Insurance Facility

The CCRIF resolves a long-standing market failure. Private insurers have not provided cost-effective insurance products to many of the smaller Caribbean countries that are vulnerable to hurricanes and other natural hazards, both because the unit transaction costs of developing insurance products for each country in isolation are very high, and because developing sophisticated actuarial risk profiles requires substantial up-front investment. The CCRIF's pooling of risks across countries, along with the WB's up-front risk modeling for the various countries, related technical work, and design of the financial setup, overcame these obstacles.

The CCRIF began operating in 2007 and now has 16 Caribbean member countries. It offers members—which pay risk-based insurance premiums to purchase desired levels of coverage—three distinct insurance products: against a hurricane of specified wind speed, against an earthquake of a specified magnitude, and (most recently) against rainfall of specified severity. Each product is designed not to insure against the losses that a disaster event would bring, but to provide rapid payouts in the wake of the event, thereby providing the liquidity needed to finance disaster response and early recovery phases—including fuel purchases, equipment hire, and overtime wages.

In addition to supporting the development of the up-front risk profile and related technical work, the WB helped put together the financial structure (acting as a financial intermediary between the facility and reinsurance markets through the WB Treasury), mobilized initial donor funding, and provided financing to help with capitalization and member countries' initial premium payments. The financial set-up of the CCRIF reflects a partnership involving a number of donors, which the WB helped to convene. The facility was initially capitalized with a grant from Japan along with capital contributions from a multidonor trust fund (which had contributions from Canada, the EU, the UK, France, the Caribbean Development Bank, Ireland, and Bermuda, in addition to the WB) as well as membership fees from the 16 member countries. WB financing included a Caribbean-wide operation (the \$45 million Caribbean Catastrophe Risk Insurance Project) that established the CCRIF and supported its initial operations. After the initial support from the WB and other development partners, all members except Haiti now fund their own premium payments, and the facility is financially self-sustaining. A separate facility under the CCRIF has recently been set up to provide similar insurance products to Central American countries.

Source: CCRIF website and various WB documents.

Box 4.5. Uruguay's weather hedge

Given Uruguay's dependence on hydropower for electricity and high exposure to the risk of drought and high oil prices (because of its need to compensate for shortfalls in hydropower generation by purchasing oil-based energy), the WB executed a US\$450 million weather and oil price insurance with Uruguay's power utility, UTE, in 2013. The hedge was reinsured by Allianz and Swiss Re. This is the largest transaction in the weather risk management market thus far, and is the first time that a public utility company has used this type of tool.

The utility was insured for 18 months (January 2014-June 2015). To measure the extent of the drought and potential insurance payouts to the company, rainfall was collected and measured daily at 39 weather stations. The utility could receive a payout of up to US\$450 million if the drought was severe enough (as measured by rain levels) and coincided with high oil prices. This weather hedge transaction was meant to cover the tail end (i.e., lower probability and higher impact) events of the same risk type addressed by Uruguay's contingent IPF transaction described in Box 4.1.

Source: Interviews, WB website, and various WB documents.

B. INTERNATIONAL MONETARY FUND (IMF)

The IMF's contingent lending instruments include the Flexible Credit Line (FCL), the Precautionary and Liquidity Line (PLL)⁴⁸, and precautionary options under the Stand-By Arrangement (SBA) and the Stand-By Credit Facility (SCF).⁴⁹ Until the mid-1990s, IMF programs were designed as ex-post crisis resolution or emergency⁵⁰ instruments, providing assistance to countries once the balance-of-payment needs had already materialized. The IMF's first "pure" contingent instrument, the Contingent Credit Line (CCL), was introduced in 1998 in response to the contagion of the 1998/1999 emerging markets crisis. However, it was never used⁵¹ and was allowed to expire in 2003. The IMF's inability to better prevent the fallout from the 2008 crisis triggered a review of the IMF's lending toolkit,⁵² resulting in the introduction of the FCL and the PCL (the PLL's predecessor), as well as modifications to the precautionary SBA. The FCL, PCL/PLL and SBA all have the same financial terms (Annex III, Tables III.1 and III.2 show general characteristics and financial terms).

The FCL, introduced in 2009, provides rapid and uncapped access to resources in times of crisis, without ex-post conditionality. Eligibility for these one- to two-year renewable arrangements is restricted to members with very strong fundamentals and records of sound policy implementation, and requests for the FCL are meant to remain confidential⁵³ (to avoid the stigma of potentially not qualifying). The only takers in 2009 were Colombia, Mexico, and Poland. In 2010, this low demand prompted the IMF to increase the FCL's attractiveness by doubling the drawdown period⁵⁴ and removing the initial expectation that access would not exceed 1000% of quota, which was deemed a potential limitation to

the instrument's signaling power. To reduce the adverse signaling effects of exit, the IMF also introduced the expectation for each successor FCL to normally be granted at a lower access level than the previous arrangement. To date, however, Colombia, Mexico, and Poland remain the only FCL users (renewed several times since 2009), and none of the resources have been drawn thus far. The lack of demand for the FCL has been attributed to the high qualification bar and concerns about losing eligibility during the drawdown period, or not being able to renew upon expiration (exit stigma).

Box 4.6. Mexico's use of the WB "Multicat" program

Mexico, which in 2006 (before the establishment of the WB Multicat program) was the first country to issue a parametric catastrophe bond to transfer earthquake risks, has twice made use of the program for bond issues. In 2009, through a special-purpose vehicle, the country issued a four-tranche, three-year multi-peril CAT bond totaling \$290 million under the program. The bond issue provided parametric insurance against earthquake risk in three regions around Mexico City and against hurricanes on the Caribbean and Pacific coasts.

In 2012 (again working through a special purpose vehicle), Mexico issued a three-tranche CAT bond totaling \$315 million that covered two additional regions (for a total of five regions) for earthquake risk. The 2012 bond issue tailored the parametric risks to a greater degree than the 2009 bond issue, and was oversubscribed.

Source: WB website and various WB documents.

While originally designed as a crisis resolution instrument, the SBA has been used in a contingent way since the 1990s. SBAs, established in 1952, are typically one- to two-year arrangements used when balance-of-payments crises originate in the current account, though on some occasions capital account needs have been addressed as well. Unlike the FCL, it requires the member to keep adhering to the negotiated program's policies and targets (*ex-post* conditionality). Precautionary SBAs have been quite popular because of their use as a signal of access to financing and soundness of policies. "About one-fourth of the SBAs granted between January 1997 and October 2008 could be deemed to have been precautionary in nature" (Reichmann and de Resende 2014).

The introduction of the FCL led the IMF to redesign the SBA to increase the usefulness of its precautionary modality. The fact that the IMF saw the FCL, which served only strong performers, as the potentially preferred instrument (given its lack of *ex-post* conditionality) reduced the SBA's attractiveness because of the stigma associated with entering into a precautionary SBA (i.e., revealing the requester's inability to qualify for the FCL). Therefore, the IMF tried to increase the precautionary SBA's usefulness by doubling its limits,⁵⁵ allowing greater drawdown front-loading, and formalizing precautionary access to amounts exceeding normal SBA limits by creating the High-Access Precautionary SBA (HAPA). Moreover, to help guard against liquidity risks and strengthen price incentives

against unduly large precautionary access, the IMF revised the commitment fee structure for SBAs, with fees increasing with the size of access. In 2009 Costa Rica, El Salvador, and Guatemala took out HAPAs, but regular precautionary SBAs have been more used (see Annex III, Table III.3). A 2014 study by the IMF's independent evaluation office (Reichmann and de Resende 2014) found that the SBA (including the precautionary modality) is still seen as having drawbacks, including the general stigma associated with requesting assistance from the IMF (especially at times when no financing is really needed) as well as the perceived uncertainty about the availability of resources at the time of need, since the ability to draw depends on performance under the program.

Since no further HAPAs or FCLs were requested, a renewed 2010 review of the IMF's crisis prevention toolkit led to the introduction of the PCL. The PCL was a one- to two-year arrangement to strengthen crisis prevention in countries that had sound policies but faced vulnerabilities that would disqualify them from the FCL. In addition to entry qualification requirements, the PCL had—unlike the FCL—some limited ex-post conditionality focused on those vulnerabilities. While qualification requirements for the PCL were expected to be less stringent than those for the FCL, room for judgment and confusion remains in interpreting what constitutes the “sound” fundamentals required for the PCL, compared to the “very strong” environment needed for the FCL. Like the FCL and the HAPA, the PCL was available only to members that did not have a current balance-of-payments need. Countries were expected to prefer the PCL, with similar qualification and access conditions as the HAPA but with lighter, more focused, and review-based conditionality, over the HAPA. By 2011, however, the PCL had only one user—FYR Macedonia. This led the IMF to make the PCL—renamed Precautionary and Liquidity Line (PLL)—more flexible by (i) allowing its use even with a current balance-of-payments need at the time of approval; and (ii) allowing a shorter arrangement duration of six months (in addition to the one- to two-year option). However, to date, only Morocco has used the PLL.

For LICs that do not qualify for the FCL, the SBA, or the HAPA, the IMF provides the option of precautionary approval for the Stand-By Credit Facility (SCF) to provide financing for short-term balance-of-payments needs. There have been six precautionary SCFs for LICs so far, including two for Honduras (see Annex III, Table III.3).

The low uptake of the IMF's contingent instruments reflects ongoing concerns about not qualifying for a certain instrument, as well as the stigma of needing, or later potentially losing, Fund support. In addition, lines between instruments have been blurred. For instance, by allowing countries to access a PLL with an already existing balance-of-payments need, the IMF made the difference between the PLL and SBA or HAPA less clear. Moreover, there is some uncertainty about where to draw the line between a country with “very strong” (for the FCL) as opposed to “sound” economic fundamentals (for a PLL). Low demand for the IMF's instruments can also be due to the fact that emerging markets in general are reducing their reliance on the Fund by expanding regional financing arrangements and networks of bilateral swap arrangements, and/or building substantial international reserve buffers for self-insurance.⁵⁶



5 Lessons Learned and Issues Going Forward

A. LESSONS LEARNED FROM IDB, MDB, AND IMF EXPERIENCE

Most countries have not been willing to pay a significant premium over regular lending terms for contingent instruments. This is shown by the IDB's experience with the DSL and CCL and the ADB's low uptake of the CSF PFO, all of which were substantially more expensive than regular borrowing. However, instruments with terms closer to normal MDB lending products, such as the CAF's liquidity line, the World Bank's DPF DDO and DPF CAT DDO, and the IDB's CCF, have been more used. The insurance-type nature of contingent instruments implies that demand can be expected to be very sensitive to the premium compared to the countries' perceived risk and expected losses. Whereas countries' perceived probabilities of a crisis and of resulting expected losses can vary substantially (depending, for example, on their economic structure, their degree of self-insurance through reserves, or their access to emergency or other financing), contingent instruments offered by MDBs have in general not had differentiated prices across countries. Demand for the DSL has been limited to two highly exposed countries (dollarized economies without a lender of last resort⁵⁷), and there has been no demand at all for the CCL. Moreover, high commitment or standby fees can lead countries to delay requests for contingent loans for as long as possible, blurring the line between contingent and emergency lending.

The cooperative nature of the international financial institutions (IFIs), manifested in uniform pricing across countries,⁵⁸ creates issues for the provision of contingent lending products. In the absence of risk-based price differentiation, the IMF and MDBs have created separate products for different country risk profiles or restricted access to contingent instruments through other means. This has complicated the use of these instruments. First, unclear criteria for eligibility leave countries unsure about which instruments are in fact available to them. Second, restricting access to certain countries can undermine the support for, and the sustainability of, the instrument class itself. Third, asymmetric information around the main access determinant—borrower risk—can lead to a situation in which approval for a contingent loan product not only is dependent on country risk, but can in turn directly affect country risk positively (through projecting strength due to IFI support) or negatively (by signaling a potential weakness, and/or by revealing a higher level of risk when not qualifying, or losing eligibility, for the desired instrument). The IMF’s experience, with its tiered system of separate instruments with differing levels of ex-ante vs. ex-post conditionality, has shown that the stigma issue, rooted in asymmetric information, remains a significant barrier to higher demand for its FCL and PLL products.

Another crucial element affecting demand for contingent products is borrowers’ certainty about the availability of quick disbursements when needed. Contingent instruments are meant to be an improvement over ex-post emergency lending with regard to automaticity and speed of disbursement in crisis times, and demand for these instruments is very sensitive to how eligibility for disbursement is determined and maintained during the drawdown period, especially if commitment or standby fees must be paid. This realization has, for example, led the IMF to eliminate ex-post conditionality and the requirement for renewed Board approval for the FCL (in contrast to its predecessor, the CCL), and motivated the WB to shift the responsibility for maintaining and communicating the eligibility status for DPF DDO disbursements from the borrower to the WB (unlike the IDB’s DSL and CCL, whose suggested “close policy dialogue” during the drawdown period had left the specific mechanics and responsibilities unclear).

For the IDB’s DSL and CCL, requiring a valid IAMC for disbursement⁵⁹ in its current form is perceived as being at odds with the goal of these instruments to respond to crises. Given that exogenous shocks of a sufficient magnitude often affect countries’ macroeconomic outlooks, eligibility under the DSL and CCL can be compromised by the same crises that the instruments are meant to protect against. This results from the fact that the IAMC—the tool used to ascertain macroeconomic eligibility—takes into account both endogenous (such as strength of institutions and policy environment) and exogenous (such as impacts from terms of trade or financial shocks) factors. In contrast, the ADB’s and WB’s macroeconomic assessments distinguish between exogenous and endogenous factors, allowing for

disbursement even when exogenous factors have deteriorated, and neither the WB's CAT DDO nor the CAF's liquidity line requires positive macroeconomic assessments for disbursement.

Other factors mentioned in OVE interviews that reduce demand for the DSL and CCL are (i) uncertainty as to whether resources are in fact available, and (ii) limited knowledge of these tools. While the instruments' limits were never officially revised after their creation in 2012, the IDB's changed financial management approach resulted in a general impression that these limits and the availability of resources in excess of country lending envelopes do not in fact unconditionally apply. Moreover, the 2015 Annual Programming Survey (IDB 2015d) revealed that knowledge of the existence of the CCL and DSL was limited: only 59% of respondents⁶⁰ reported being familiar with the CCL, and just 14% knew of the DSL.

The poorest countries typically do not have access to contingent lending instruments for financial and economic crises. The WB limits its DPF DDO to IBRD countries, the IDB limited the DSL and PBL DDO to OC and OC/FSO blend borrowers, the ADB restricts the CSF PFO to non-ADF countries, and the CAF approves contingent liquidity lines only for frequent issuers in international bond markets. Only the IMF's SCF can be used by LICs in a precautionary way. While countries accessing resources on largely concessional terms may not have strong incentives to delay borrowing for development needs and the capacity of MDBs to cover crisis risks for these countries can be limited, it may be worthwhile to better explore the interest of LICs in using such risk management tools for financial and economic crises. There are more coverage options for natural disaster risks with the IDB's CCF and the WB's IRM (and, in general, IPF with contingent components), and other risk-pooling tools are available to all countries, including those relying on concessional funding.⁶¹

There are alternatives to MDBs' covering of risks for which there is market appetite. Especially in the case of natural disaster and other weather-related risks with straightforward measurement and verification possibilities, the undersupply of affordable insurance options is often rooted not in a lack of financing, but rather in other market failures (such as the high transaction costs of properly analyzing risks⁶² and setting up instruments, standardizing products, and coordinating the pooling of risks). By providing technical assistance, advisory services, or small loans, MDBs can address those market failures directly instead of trying to cover the risks themselves. As the WB's experience shows—with its Multicat bond program, the Uruguay hydrological hedge, the CCRIF, and the Pacific Catastrophe Risk Insurance Pilot—MDBs can effectively act as intermediaries and market facilitators, rather than exclusively as finance providers. By crowding in initial grant resources, market financing, and/or (re)insurance, this approach not only allows for better leveraging of scarce MDB resources, but can also help create more sustainable risk management solutions for countries.

B. SUGGESTIONS AND CONSIDERATIONS FOR THE UPCOMING REVIEW OF IDB SG LENDING INSTRUMENTS

The extent to which, and how, the IDB can and should dedicate its finite resources to crisis lending is a decision for the governance bodies of IDB – the Board of Governors and the Executive Directors. Rather than issuing specific recommendations, this review focuses on highlighting relevant trade-offs and issues to bear in mind when considering this topic.

Decisions around whether, and in which form, to reintroduce emergency and/or contingent lending products need to strike a reasonable balance between the interests and constraints of the IDB and its various member countries and can be informed by recent IDB and IFI experience. Given the importance and complexities of the decisions involved, OVE's main suggestion is to conduct careful and comprehensive consultations with stakeholders (including member countries and IDB Management) regarding needs and preferences concerning the key issues outlined below.

1. IDB's countercyclical role and capacity

The need for contingent lending instruments for financial and economic crises is intrinsically linked to the extent to which the IDB is expected to play a countercyclical role.⁶³ Given the opportunity cost—in terms of lower levels of ongoing development lending—of accumulating resources during “good times” for increased lending in “bad times,” the IDB member countries’ interests are not always aligned on this topic. And trade-offs in preferences between current and future countercyclical flows may be exacerbated by the fact that not all countries have been eligible to use contingent products in practice.⁶⁴

An argument often advanced is that financial crisis lending is the domain of the IMF, with MDBs having neither the mandate nor the resources to fulfill this role effectively. As previously mentioned, this position was taken implicitly in a 2010 Management proposal (GN-2564-1, not approved) that suggested eliminating the IDB's emergency lending category because of the IMF's introduction of the FCL. Despite this argument, MDBs have responded to demand by their member countries for countercyclical lending, motivated in part by a perceived gap between the IMF's financing for balance-of-payment shocks and more general government budget needs for countercyclical spending in more broadly defined economic crisis scenarios. However, the OVE review has revealed some persistent doubts about the size of this gap, given the fungibility of money.⁶⁵

In addition to questions of mandate, relevant financial considerations also weigh on MDB's ability to provide additional crisis lending. Especially for the IDB, the cost and ability of building, maintaining, and effectively using buffer resources for crisis lending are influenced by the Bank's relatively concentrated portfolio⁶⁶ and thus

more limited diversification options (than the World Bank and IMF, for example). Economic downturns are often correlated among countries, exacerbating the effect on the Bank's balance sheet.⁶⁷ The constraints on IDB lending put in place by the new Capital Adequacy Policy (AB-2994, AB-2996) and the amended and restated Income Management Model (AB-3044) are all the more binding in times of financial and economic crises, when increased demand for lending often coincides with sovereign downgrades and thus further reduced IDB lending capacity. The small size of the IDB vis-à-vis the region's financing needs⁶⁸ and the considerable opportunity costs of reserving funds for playing a quite limited countercyclical role imply that the IDB has to carefully consider to what extent it can and should strive to reserve additional funds for crisis lending. This is all the more important as a potential shift toward more crisis lending (at the expense of regular development lending) can affect the volatility and size of the IDB's balance sheet, and thus also its operational capacity to respond to shocks when needed.⁶⁹ At the same time, interviews suggest that the extent to which the IDB plays a countercyclical role can influence how relevant the IDB remains, especially for more advanced member countries that have less need for MDB financing in "good times."

2. Joint vs. individual saving for bad times

Linked to the topic of buffer size is the question of whether countercyclical lending should be outside of countries' regular lending envelopes. Especially for countries with relatively lower MDB financing needs under normal circumstances, the use of contingent lending instruments (such as the PBL DDO) can result in an efficient use of their regular IDB lending envelope in "good times" and ensure resource availability in crisis situations, even without necessarily tapping additional resources. Other countries rely on the availability of excess resources when a crisis hits, as their lending envelopes are fully used by current borrowing. Both approaches are manifestations of preparing for "bad times." The main distinction is that building a general buffer for crisis lending implies the joint pooling of resources by all countries (through lower regular borrowing in good times by all), whereas the use of contingent instruments within countries' regular lending envelopes shifts the responsibility of saving for bad times (and the consequences of a failure to do so) more to each individual member. Through the requirement of a smaller buffer, saving individually (i.e., within country envelopes) can result in larger regular lending envelopes than the joint buffer approach. Depending on current vs. contingent borrowing preferences, vulnerability to crises, and eligibility to borrow from a joint buffer in crisis times, countries' views on what constitutes the best approach can diverge significantly.

3. Options for lending instruments

Another consideration is to what extent crisis lending should be done through an instrument that is distinct from the IDB's regular lending tools (i.e., PBLs and investment loans).⁷⁰ Crisis lending and contingent tools do not necessarily need to

constitute a separate instrument category. As the CCF's success has demonstrated, existing instruments can be adapted to fit such needs. PBLs have often been used *as de facto* crisis lending,⁷¹ and PBL DDOs as contingent instruments for deteriorating financial conditions. While PBLs are not *a priori* designed for (or their use limited to) shock scenarios, countries have preferred the pricing and flexibility of these tools over the DSL whenever they were eligible for them and had space in their country lending envelopes. When PBLs are used for such purposes, the reform focus can take a back seat to the country's financing needs. One option could be to introduce a specific PBL and PBL DDO variant for crisis or shock scenarios, with simpler policy conditionality (for example, with an emphasis on maintaining pro-poor programs, similar to the DSL). Such a loan could have a higher loan charge to discourage overuse at the expense of regular PBLs. Non-crisis PBLs could then focus more on deeper, more forward-looking reforms, thereby addressing the issue of low-depth and/or pre-met conditionality highlighted in OVE's recent review of PBLs (RE-485-6).

a) Emergency vs. contingent (vs. both) lending

Conceptually, two options allow access to additional (buffer) resources beyond countries' regular lending envelopes. The first option, taken by the IDB's DSL and CCL, is to use a separate product to access such buffer resources. In the absence of clear funding rules, a drawback of this approach has been the perceived tying of the instrument's existence to the availability of the buffer. An alternative could be to allow exceptional access to amounts exceeding country envelopes through regular lending instruments. In each case, accessing excess resources could be subject to higher pricing and/or other conditions (as well as contingent on buffer availability).

When considering its countercyclical role, the IDB needs to decide whether to offer ex-post emergency or ex-ante contingent lending, or a combination of both. Contingent loans allow certain countries, with an up-front fee, to "pre-reserve" additional liquidity for shock scenarios, whereas with emergency lending the available resources are allocated only after a crisis hits. Other than an implicit desire to more quickly commit increased resources created by the IDB-9 capital contribution schedule (AB-2890), no conceptual or demand-based reason was given for the IDB's switch from emergency to contingent lending in 2012. In the upcoming review of the IDB's lending toolkit, the advantages and drawbacks of both approaches should be weighed carefully.

A major advantage of ex-post emergency lending is that actual resource needs may become clear only after a crisis materializes, and therefore funds can be allocated fairly and efficiently. Relying on ex-post emergency lending prevents buffer resources from being fully committed to some countries and thus unavailable if an unforeseen shock hits another country. Another minor advantage of the less-than-certain nature of ex-post emergency financing is that it avoids the possible

moral hazard of contingent instruments,⁷² which can require close monitoring. Emergency lending can also circumvent the difficulties in determining how unanticipated the shocks must be to qualify for contingent support. IDB and other IFI experience has shown that drawing this line can be artificial⁷³ or can create undue complexity—as in the DSL case, when specific crisis triggers had to be defined *ex ante* (i.e., anticipated), yet high standby fees motivated countries to delay approval for as long as possible.

Contingent instruments also have advantages. First, the speed of disbursement after a shock can be faster because the operation has already been designed, approved, and signed. Second, if large enough, contingent instruments can have important signaling effects, in that markets can be reassured by the availability of IFI resources when needed. This can even lower the risk that a crisis event will materialize in the first place, or reduce the magnitude of the fallout. Third, from IDB's point of view, standby fees on contingent instruments can compensate for the set-aside of buffer resources better than investing them in instruments that are liquid enough for emergency lending. Fourth, standby fees for contingent instruments can serve as a self-selection tool to allocate scarce buffer resources, in that resources are allocated to the countries most motivated to pay up-front fees in return for assured support. Fifth, explicitly reserving resources under committed contingent lending products can potentially help overcome the political economy constraints MDBs can face when trying to save through reduced lending or higher loan charges in good times.

OVE's review suggests that some combination of contingent and emergency lending may be most appropriate for financial and economic shocks. Increased financing needs arising in a crisis are unlikely to be fully and fairly met by preapproved contingent funds, and reserving some resources for emergency lending is arguably appropriate.

b) Financial and nonfinancial terms and conditions

If the IDB decides to continue offering contingent lending products, the importance of carefully designing their financial terms cannot be overstated. OVE's interviews and demand analysis indicate that price sensitivity may be higher for the front-end and standby fees than for the lending spread. As shown by the demand for the IDB's even more expensive Emergency Lending (400 bps/year over the IDB's cost base), in crisis situations countries are often willing to pay a high premium compared to regular IDB borrowing, as their options for alternative financing on comparable terms are typically limited. In contrast, front-end and standby fees have to be paid in comparatively "good times," when countries may find it hard to justify expenses aimed at covering the risks of uncertain future events. Given the very limited uptake of the DSL and the absence of demand for the CCL (with even higher commitment fees), it may be appropriate to reconsider the premium (over the IDB's normal credit fee on undisbursed balances) on undrawn contingent line amounts, to make

sure it is in line with the cost and usage objectives of a potential future contingent instrument. From the IDB's financial perspective, reserving and holding liquidity for disbursement under a contingent line does not differ in cost from holding such resources for disbursement under regular loans. On the other hand, monitoring costs may be somewhat higher under contingent instruments than for other undisbursed balances, and setting pricing too low can affect countries' incentives for investing in crisis mitigation and self-insurance measures. To the extent that such incentives are a concern to the IDB, however, setting appropriate limits in terms of amounts, as well as applying focused conditionality⁷⁴ for the use of these instruments, can mitigate some of these moral hazard issues.

Other than price, the efficient use of contingent instruments also hinges on their nonfinancial conditions. As previously mentioned, the requirement of a valid IAMC in its current form⁷⁵ for disbursement under the DSL and CCL was seen as contrary to the instruments' purpose of supporting countries in external shock scenarios. The IDB could consider following the example of the ADB and WB in differentiating between endogenous and exogenous factors when determining macroeconomic conditions for contingent instruments, and not requiring an IAMC for disbursements under natural disaster coverage (similar to the CCF and the WB's CAT DDO, which does not require the monitoring of macro conditions after approval). Another measure to correct misaligned incentives would be to allow for a suspension of standby fees upon the loss of eligibility, for the time it takes the borrower to restore full access. Finally, the onus of regularly monitoring and communicating eligibility should be on the IDB, by clearly establishing that borrowers have immediate access to resources when needed, unless they have previously been notified otherwise by the IDB.

Moreover, the usefulness of requiring specific quantitative triggers under contingent instruments for financial and economic crisis could be reevaluated. OVE's evaluation found that none of the other IFIs' contingent products set specific quantitative triggers in advance, but rather specify more general and flexible drawdown conditions. This can ensure the usefulness of contingent instruments even for crisis events that do not materialize exactly as foreseen, and can help avoid lengthy discussions during project preparation as to what should constitute appropriate triggers and thresholds.

Especially for the CCF, the IDB could consider allowing for open-ended drawdown periods, since those risks tend not to disappear over time. By following the CAF's example and allowing for unlimited renewals, the instrument could be more aligned with the ongoing nature of such risks. Moreover, allowing for open-ended drawdown periods could help avoid situations in which countries choose to delay accessing the contingent instrument to ensure as much future coverage as possible.

There should be clear rules on the source and availability of funds for contingent instruments. The confusion around the DSL's and CCL's continued availability should be avoided, as countries need clarity about which instruments they can access

and how. Among other issues, the IDB needs to clarify whether, and under which conditions, a country can pre-reserve buffer resources under contingent instruments when the borrower still has available space in its country lending envelope.

c) Expanded eligibility

In light of the limited number of countries qualifying in practice for accessing buffer resources under the DSL (and within country envelopes under the PBL DDO), the IDB could explore the possibility of expanding access to contingent instruments for economic crises to more borrowing member countries. While any such expansion would of course have to be carefully weighed against the Bank's risk absorption capacity and available resources, it could help address certain asymmetries in countries' access to risk management tools. As the use of PBL DDOs by Peru and Uruguay shows, countries that would have qualified for buffer resources under the DSL often have ample access to alternative financing in good times, and thus may have more flexibility for (i) using their regular IDB lending envelopes to prepare for crisis events, and (ii) self-insuring, for example via building international reserves. At the same time, poorer countries may have a strong interest in accessing buffer resources in crisis times. They often lack alternative financing sources even under normal circumstances, and their large and urgent development needs can lead to a comparatively larger opportunity cost of (i) not fully using their IDB lending envelope, and (ii) self-insuring via saving in good times. While countries with access to international capital markets may be more vulnerable to shocks to the capital account, poorer countries can be equally or even more vulnerable to other economic shocks, such as those emanating from the current account.

4. Demand and IDB capacity as a risk intermediary

For natural disaster risks for which there is investor or reinsurance market appetite, there may be potential for the IDB to better leverage its resources by intermediating between countries and the markets. As in the WB examples, IDB resources could potentially be more efficiently used by seeking to address failures in insurance markets rather than absorbing all risk on the IDB's balance sheet. Effective intermediation can have important externalities by creating markets in which investors' or reinsurers' demand for such risks is matched to country needs.

In addition to covering natural disasters, the IDB could consider offering risk management products for a wider array of weather-related risk events. As the WB's transactions with Uruguay's UTE have shown, countries can be severely affected by weather-related, non-disaster events. MDBs may have a role in providing contingent products for such scenarios, or by intermediating between borrowers and markets.

- ¹ Contingent lending consists of ex-ante arrangements to guarantee the availability of funds in anticipation of an actual financing need, usually conditional on the occurrence of a certain state or event.
- ² The DSL expired “for the purposes of the approval of new loan operations” (AG-9/12).
- ³ According to a 2015 estimate, only about 13% of potential disaster-related economic losses are insured in Latin America, as compared with 44% in North America and 24% in Europe. *Source:* <http://www.air-worldwide.com/publications/white-papers/documents/2015-global-modeled-catastrophe-losses>
- ⁴ The significance of this difference is in practice somewhat reduced by the fact that many financial and economic crises result in balance-of-payment crises, as well as by the possibility of central banks’ lending to governments for stimulus spending, or of increased central bank resources improving sovereign borrowing terms.
- ⁵ Technically, the PBL DDO is a disbursement modality of PBLs, and not a separate instrument class. This review, however, subsumes the PBL DDO under contingent instruments as it can be used by countries for contingent financing needs.
- ⁶ AB-2890 established that such programs could include efforts to “(i) support efforts to maintain or strengthen the reform process in the social, institutional and economic areas; (ii) protect funding for social programs that benefit the poor; (iii) support new efforts to mitigate the effects of crisis on the poor and vulnerable; (iv) protect investment expenditure for Bank financed projects where the government is facing difficulties in funding counterpart requirements; and (v) provide liquidity to regulated financial institutions to finance short-term working capital operations and trade financing for micro, small and medium scale enterprises.”
- ⁷ The EMBI (Emerging Market Bond Index) is JP Morgan’s index of the dollar-denominated sovereign bonds issued by a selection of emerging market countries.
- ⁸ Since AB-2990 is silent on the DSL and its specific IMF Article IV (or comfort letter) requirement, it is understood that a positive IAMC was a necessary and sufficient condition for the Bank to approve (and disburse) a DSL.
- ⁹ Listed examples include a fall in the price of an export commodity, a rise in the price of an imported commodity such as oil or food, a decline in growth of important trade partners, or a direct drop in a macroeconomic variable.
- ¹⁰ This means that, if the full US\$2 billion was not fully used in one of these years, the available amount would increase by the unused amounts for the following years, up to a total of US\$6 billion (see AB-2890).
- ¹¹ See Chapter III.D (Financial considerations) for more details.
- ¹² As a precedent for the DSL, the country was among the few IDB borrowing member countries that had requested the Liquidity Program for Growth Sustainability (ES-L1029) in 2008. Of the US\$400 million approved under that program, El Salvador used less than half.
- ¹³ To justify the relatively limited amount, the loan proposal mentions Ecuador as an example for some liquidity funds starting out with just one percent of deposits. The source cited (Weisbrot, Johnston and Lefebvre 2013), however, establishes that Ecuador’s banks were to contribute three percent of deposits (later increased to five percent) to the fund from its inception, with initial resources being lower only during the ramp-up time of a few months.
- ¹⁴ OVE’s interviews suggest that there was an impression of some positive signaling effect on markets.
- ¹⁵ Fee changed as per FN-700-4.
- ¹⁶ The IDB’s contingent products for natural disasters (CCF, CCL) emanated from the IDB’s Integrated Disaster Risk Management and Finance Approach (GN-2354-7). As such, CCF operations are usually accompanied by comprehensive IDB support to more generally improve countries’ disaster risk management capacities.

- ¹⁷ The IDB uses recognized international providers of hazard data for parametric calculations (AB-2890). The development, design, and verification of appropriate parametric triggers have been cited as challenges of the instrument.
- ¹⁸ By redirecting funds, the objectives and results of the affected investment operations can be compromised. The CCF is therefore restricted to severe disasters which might in any event affect the execution of previously approved investment projects.
- ¹⁹ For redirected funds, this means that the original IPF tenors (of the operations under which the redirected resources were approved) no longer apply once the funds are disbursed under the CCF.
- ²⁰ Ecuador later replaced its initial US\$100 million operation with a US\$300 million CCF.
- ²¹ See Chapter III.D. for more details.
- ²² The Capital Utilization Ratio became the formal lending constraint since at least the 2014 LTFP (see paragraph 2.10 of FN-683-1).
- ²³ Since the DSL expired at the end of 2015, in practice this only applied to the CCL.
- ²⁴ Given the limited use of the IDB's contingent instruments, it is not possible to ascertain whether it could be appropriate to distinguish between undrawn amounts under contingent lines and regular undisbursed loan balances (for example, based on potential differences in the disbursement speeds and probabilities).
- ²⁵ Within each country's single borrower limit.
- ²⁶ In 2009, the ADB approved \$2.5 billion in (non-contingent) CSF assistance for five countries: Bangladesh, Indonesia, Kazakhstan, the Philippines, and Vietnam.
- ²⁷ Used when the ADB loan is part of a larger international rescue operation (usually involving the IMF).
- ²⁸ Eligibility for the ADF is based on per capita gross national income and creditworthiness. As of March 2016, 17 of the ADB's 48 borrowing member countries were eligible for ADF resources only and thus do not qualify for the CSF.
- ²⁹ In 2009, the ADB approved the US\$1 billion Public Expenditure Support Facility Program for Indonesia, under which disbursements were contingent on Indonesia's having difficulties accessing market finance (because of global and/or domestic liquidity constraints).
- ³⁰ While the internal review is not limited to IMF assessments, approval requires Article IV consultations with the IMF within the previous 18 months and an IMF letter.
- ³¹ *Source:* Interviews with ADB counterparts.
- ³² ADB. Operations Manual Bank Policies. OM Section D4/BP.
- ³³ See Table VI.5 in Annex VI.
- ³⁴ The WB's name for budget support instruments changed over time—from *adjustment lending* to *development policy lending* (in 2004) and later to *development policy financing* (in 2013). For simplicity, we use *development policy financing* (DPF) throughout.
- ³⁵ Renewable once, subject to Board approval.
- ³⁶ Verification of the adequacy of the macroeconomic policy framework is not embodied in a specific document, as opposed to the IDB's IAMC. In practice, IMF views carry a very significant weight (see WB's Operational Policy 8.60, *Development Policy Financing*).
- ³⁷ Only Latvia in 2002 (not drawn down) and Chile in 2003 (drawn down) had DDOs between 2001 and 2008.
- ³⁸ See Annex IV, Table IV.3, for the DPF DDO's pricing changes.
- ³⁹ A 2006 review of WB engagement with middle-income countries had identified this demand (see World Bank 2006a).
- ⁴⁰ See Annex IV, Table IV.3, for the evolution of the CAT DDO's pricing.

- ⁴¹ The IDB's equivalent of IPF operations is the investment loan. Emergencies include natural disasters and man-made crises.
- ⁴² An emergency was defined broadly as "an event that has caused, or is likely to imminently cause, a major adverse economic and/or social impact associated with natural or man-made crises or disasters."
- ⁴³ The trigger does not need to be parametric, and the borrowing country is not strictly required to declare an emergency.
- ⁴⁴ IDA has a dedicated funding source for ex-post response—the Crisis Response Window—but there is no ex-ante allocation of such funds.
- ⁴⁵ The WB has since also created a similar pilot catastrophe risk insurance program for Pacific Small Island States.
- ⁴⁶ Maturity is up to 10 years, but is typically 3-5 years.
- ⁴⁷ A government-sponsored special-purpose vehicle (SPV) issues the CAT bonds, which are placed with investors through investment banks. The SPV invests the proceeds in AAA-rated assets, and pays coupons to the investors from the returns on the investment and the premium paid by the country. If no event occurs during the life of the bond, the SPV returns the entire principal to the investor at maturity. If the trigger condition is met—that is, a covered event occurs—the SPV liquidates the assets it holds and pays the sponsor all or part of the proceeds, in accordance with the terms of the bond. *Source:* MultiCat Program product note, World Bank.
- ⁴⁸ Originally, the Precautionary Credit Line (PCL).
- ⁴⁹ Only the SCF is available to low-income countries (LICs).
- ⁵⁰ See Annex III, Box III.1, for a description of the IMF's emergency facilities.
- ⁵¹ Reasons cited for the lack of demand included concerns about the stigma associated with accessing (and potentially failing to qualify for) a contingent Fund instrument, and the non-automaticity of drawdowns due to additional approval requirements for disbursement. See Annex III for more details.
- ⁵² See Annex III and Box III.2 therein for more details.
- ⁵³ Qualification discussions are not public, but once the program is approved, full disclosure is provided.
- ⁵⁴ For a period of one year without interim review, or two years with a review of qualification halfway through.
- ⁵⁵ To 200% of quota in any 12-month period (from 100), and a cumulative access of 600% of quota for the duration of the program (from 300).
- ⁵⁶ See IMF (2014) and Reichmann and de Resende (2014) for more details.
- ⁵⁷ In El Salvador's case, the high pricing also led the country to request only one-third of the full possible amount.
- ⁵⁸ While not relevant to most MDBs' contingent lending products (as they tend to be restricted to countries borrowing on non-concessional terms), the only country-based pricing distinction usually made is that between countries accessing MDB resources at concessional vs. non-concessional terms.
- ⁵⁹ The IAMC requirement for approval seems to be less of a concern, unless a purely external shock is already under way and influencing the IAMC.
- ⁶⁰ The survey was conducted with "high level government officials working in the ministries of Finance, Planning or related areas who participate in the annual programming process for their countries."
- ⁶¹ However, the World Bank's CAT DDO is restricted to IBRD countries only.

- ⁶² The IDB (INE/RND) has undertaken important work to address this issue by modeling natural disaster risks for 13 IDB borrowing member countries (see, for example, IDB 2014f for Jamaica).
- ⁶³ For more background and information on the IDB's countercyclical role, see for example the Background Paper for the Action Plan for the Review of the IDB's Sovereign Guaranteed Lending Instruments (GN-2837-1).
- ⁶⁴ The terms and conditions of the DSL restricted the use of this instrument to OC borrowers, i.e. excluding the D2 countries (Belize, Guyana, Honduras, Nicaragua, and Haiti). The requirement for a positive macroeconomic assessment (or valid IAMC) reduced the number of eligible countries even further. The same is true for PBLs, which countries have *de facto* used countercyclically on many occasions: see OVE's Annual Report Technical Note: Design and Use of Policy-Based Loans at the IDB (January 2016) or Background Paper for the Action Plan for the Review of IDB's Sovereign Guaranteed Lending Instruments (GN-2837-1, February 2016).
- ⁶⁵ Examples cited for the fungibility argument are the widespread practice of central bank lending to governments in crisis times, as well as the positive effect of increased central bank resources on governments' borrowing terms.
- ⁶⁶ Recent exposure exchange arrangements with other MDBs (FN-701) have sought to alleviate portfolio concentration to some extent.
- ⁶⁷ Natural disaster risks, by contrast, tend to be uncorrelated across countries, and uncorrelated with economic cycles, so they have less systematic impacts.
- ⁶⁸ GN-2837-1 states that the IDB's lending envelope—as projected by the most recent LTFP (FN-700-4)—can contribute to only about 4% of the region's estimated financing needs.
- ⁶⁹ On the IMF's struggle to respond to the 2008 crisis after downsizing because of lack of demand in previous years, see <http://www.imo-imf.org/imo/files/completedevaluations/Annex%202.pdf>.
- ⁷⁰ Decisions about the instrument class and features can, to some extent, have implications for how flexibly these products can be administered, depending on the level of approval authority (Board of Executive Directors vs. Board of Governors).
- ⁷¹ See, for example, RE-485-6 and GN-2837-1.
- ⁷² Depending on contingent instruments' cost and design characteristics, countries' use of such products can affect their incentives for strengthening resilience and self-insurance. One example of this is the PBL DDO, whose front-end and standby fees can be more attractive than raising and holding reserves of a similar amount for certain countries.
- ⁷³ The ADB and the CAF, for example, allow for use of their contingent instruments when a crisis is already on the horizon or materializing. The IMF's Standby Arrangement also offers both precautionary and emergency uses, and the PLL can be approved when a crisis is already on the horizon.
- ⁷⁴ An example of such conditionality is the requirement for continued investment in an IDRMM under the CCF and CCL. Another example could be to require sustained reserve build-up in case of concerns that, for instance, a PBL DDO is substituting for international reserves with its comparatively attractive financial terms in some countries.
- ⁷⁵ An evaluation of IAMCs is part of OVE's 2016/17 work program.

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