CASE STUDY

Taking the Risk out of Interest Rate Risk

Using the IBRD Flexible Loan to Protect Countries against Interest Rate Risk

OVERVIEW Interest rate risk can increase debt servicing costs, putting pressure on the country's budget and imposing either spending cuts or tax reforms. The World Bank helps countries use market-based risk management tools to manage such risks. For almost two decades, the World Bank has assisted over 40 countries with a combined US$70 billion portfolio in using the IBRD Flexible Loan.

Local fisherman in Mexico, Photo Credit: Curt Carnemark / World Bank

Background

Governments borrow from the global financial markets to fund key development objectives such as quality education, clean energy and infrastructure. However, borrowing at floating interest rates may expose borrowers to interest rate risk. Countries that have a higher percentage of their debt portfolio in floating interest rates may see interest payments increase dramatically with the upsurge of the reference rate.

Materialization of interest rate risk can increase debt servicing costs, putting pressure on the country's budget. If governments want to avoid a subsequent rise in the fiscal deficit, they are forced to impose spending cuts, tax reforms, or both, and both are politically difficult to implement. Interest rate risk disproportionately affects developing countries, who often have limited financial capacity to bear these risks. As part of their debt management strategies, many governments establish targets or benchmark ranges for key risk indicators to guide borrowing activities and other debt transactions. One of the ways that a country can achieve the target mix of fixed-versus-floating rate debt is by fixing the interest rates on loans.

Financing Objectives

- Reduce interest rate risk of public debt stock.
- Keep the floating-versus-fixed interest rate ratio within the target benchmarks as outlined in the debt management strategy.
- Smooth out budget pressures due to interest volatility by fixing the rate on a portion of a country's borrowings, thus achieving a certain, fixed, constant, long term debt servicing obligation

Financial Solution

Fixing the interest rate on the IBRD Flexible Loan (IFL) can help countries mitigate interest rate risk. The IFL is based on a floating reference rate, usually six-month LIBOR, plus a spread that is either fixed over the life of the loan or variable from one semester to another. Borrowers can therefore benefit from decreases in interest rates during the life of the loan while having the option to fix the interest rate as part of a debt management strategy.

As per "Interest Rate Risk Management -Product Note",borrowers can fix the interest rate on IBRD loans using:

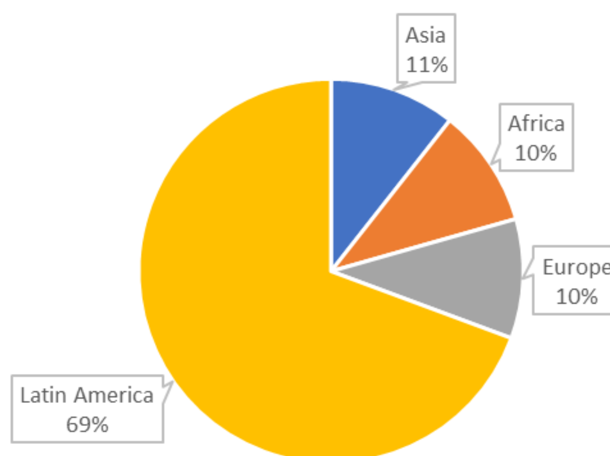
1) **Conversions:** Conversions are the most commonly used solution by IBRD borrowers. Provisions in the loan agreement allow the borrower to fix the interest rate of all or part of the disbursed and outstanding balance of an IBRD loan. Borrowers have to select the option to add these provisions in the loan agreement during negotiations. They can establish a pre-specified schedule of rate fixings (e.g., on each interest payment date, annually or on some other frequency) at loan negotiation or request conversions on an ad hoc basis anytime during the life of the loan. They can also unfix or refix the rate on disbursed amounts at any time during the life of the loan.

2) **Interest rate swaps:** IBRD interest rate swaps allow the borrower to fix the interest rate risk not only on new IBRD loans and legacy loan products such as IBRD Variable Spread Loans (VSLs), but also on non-IBRD liabilities to third parties (e.g. outstanding bonds or loans with other lenders), thus allowing a comprehensive interest rate risk management strategy to IBRD clients

3) **Interest rate caps and collars:** The borrower can also use interest rate caps and collars for protection against rising interest rates. Interest rate caps are individually negotiated transactions which set an upper limit on the interest a borrower would pay on a floating rate loan. Interest rate collars are individually negotiated transactions which set an upper and a lower limit on the interest a borrower would pay on a floating rate loan.

Outcome

Since 2001, IBRD borrowers in more than 40 countries have fixed the interest rate on their IBRD portfolio for a total of US$70.2 billion.



Latin American countries in particular, especially Mexico with a cumulative (matured and outstanding) total of US$ 13.5 billion, have chosen to fix sizeable portions of their IBRD portfolio with the objective of partially insulating its debt service obligations from interest volatility.

Advantages of working with IBRD to fix interest rates

- IBRD has a AAA credit rated rating, which reduces the country's exposure to counterparty risk.
- IBRD does not require borrowers to post collateral or charge additional fees in lieu of collateral.
- IBRD does not charge borrowers for credit risk and provides the same competitive pricing to all borrowers.
- Loan conversions are administratively simple for borrowers. Conversion provisions are embedded in the IBRD loan. No additional documentation is required.
- IBRD can provide technical assistance and capacity building in derivative pricing and execution.

Interest rate fixing is one of the many ways the World Bank Group helps member countries become more resilient to economic shocks. IBRD's triple A credit rating, market presence and convening power allows the World Bank Treasury Financial Products team to develop innovative new products to help our clients maximize financing and mitigate risk

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