

CASE STUDY

# Taking the Risk out of Interest Rate Risk

Protecting Countries against Interest Rate Risk with IBRD Flexible Loans

## OVERVIEW

Interest rate risk can increase debt-servicing costs, putting pressure on national budgets and forcing countries to impose spending cuts or tax reforms. The World Bank helps countries manage this risk with market-based risk management tools such as the IBRD Flexible Loan (IFL). Over the past 17 years, the World Bank has helped over 40 countries with a combined US\$70 billion portfolio use the IFL.



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 high-quality education, clean energy, and needed infrastructure. But borrowing at floating interest rates may expose governments to interest rate risk. Countries that have a high percentage of their debt portfolio in floating interest rates could see interest payments increase dramatically with the upsurge of the reference rate.

If interest rate risk materializes, countries face higher debt-servicing costs, which put pressure on the country's budget. To avoid a subsequent rise in the fiscal deficit, countries may be forced to take the politically difficult step of imposing spending cuts, tax reforms, or both.

Interest rate risk disproportionately affects developing countries, which often have limited financial capacity to bear this risk. 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 way that a country can achieve the target mix of fixed-rate versus floating-rate debt is by fixing the interest rates on loans.

## Financing Objectives

The [IBRD Flexible Loan](#) allows countries to meet several objectives:

- Reduce interest rate risk of public debt stock
- Keep the ratio of floating interest rate to fixed interest rate within the target benchmarks as outlined in the debt management strategy
- Smooth out budget pressures arising from interest volatility by fixing the rate on a portion of the country's borrowings, thus ensuring a long-term debt-servicing obligation that remains the same over time

## Financial Solution

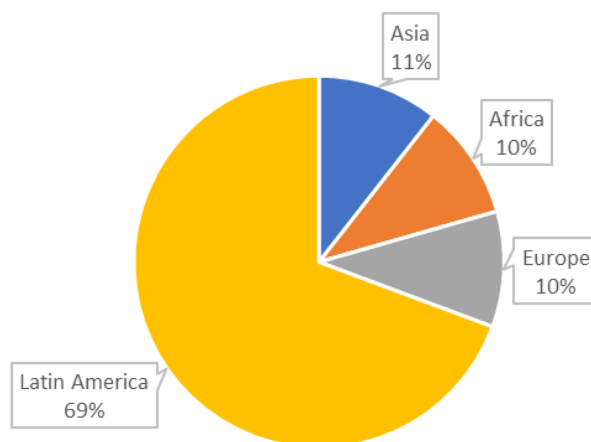
Fixing the interest rate on the IFL can help countries mitigate interest rate risk. The IFL is based on a floating reference rate, usually the six-month LIBOR, plus a spread that is either fixed over the life of the loan or variable from one semester to another. Borrowers can therefore benefit from decreases 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 explained in a [World Bank product note on managing interest rate risk](#), borrowers can fix the interest rate on IFL in several ways:

1. **Conversions.** Conversions are the solution most commonly used by IBRD borrowers. Provisions in the loan agreement—which borrowers have the option of adding when the agreement is being negotiated—allow the borrower to fix the interest rate of all or part of the disbursed and outstanding balance of an IBRD loan. At the time of loan negotiation, borrowers can establish a schedule for rate fixings (e.g., at each interest payment date, annually, or at some other frequency); or they can request conversions on an ad hoc basis at any time 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 offer a comprehensive interest rate risk management strategy: they allow borrowers to fix the interest rate not only on new IBRD loans and legacy loan products, such as IBRD Variable Spread Loans, but also on non-IBRD liabilities to third parties (e.g., outstanding bonds or loans with other lenders).

3. **Interest rate caps and collars.** Borrowers can also use interest rate caps and collars for protection against rising interest rates. These are individually negotiated transactions that set limits on the interest a borrower pays on a floating-rate loan—an upper limit in the case of an interest rate cap, and an upper and a lower limit in the case of an interest rate collar.



Share of countries that have fixed the interest rate on their IBRD loans

## Outcome

**Since 2001, IBRD borrowers in more than 40 countries have fixed the interest rate on IBRD loans totaling US\$70.2 billion.**

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

## Advantages of Working with IBRD to Fix Interest Rates

IBRD is well positioned to help countries fix interest rates:

- IBRD has an AAA credit 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, with conversion provisions 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 ways the World Bank Group helps member countries become more resilient to economic shocks. IBRD's AAA credit rating, market presence, and convening power allow the World Bank Treasury Financial Products team to develop innovative new products to help our clients maximize financing and mitigate risk.