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**Working Paper**

## On the Preferred Creditor Status of Multilateral Development Banks

CESifo Working Paper, No. 10521

**Provided in Cooperation with:**

Ifo Institute – Leibniz Institute for Economic Research at the University of Munich

*Suggested Citation:* Amegashie, J. Atsu (2023) : On the Preferred Creditor Status of Multilateral Development Banks, CESifo Working Paper, No. 10521, Center for Economic Studies and Ifo Institute (CESifo), Munich

This Version is available at:

<https://hdl.handle.net/10419/279271>

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## **Impressum:**

CESifo Working Papers

ISSN 2364-1428 (electronic version)

Publisher and distributor: Munich Society for the Promotion of Economic Research - CESifo GmbH

The international platform of Ludwigs-Maximilians University's Center for Economic Studies and the ifo Institute

Poschingerstr. 5, 81679 Munich, Germany

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Editor: Clemens Fuest

<https://www.cesifo.org/en/wp>

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# On the Preferred Creditor Status of Multilateral Development Banks

## Abstract

The loans of the IMF, World Bank, and other multilateral development banks (MDBs) are excluded from debt restructuring. This is the result of their preferred creditor status. There are two justifications for the preferred creditor status of MDBs: (a) they give concessional loans, and (b) they give loans to debt-distressed countries when other lenders would not. In this note, I present a conceptual framework that quantifies the benefit in case (b), discard the preferred creditor status of MDBs, and outline a debt restructuring process that includes MDBs. I also discuss a similar approach by Diwan, Harnoys-Vannier, and Kessler (2023), which also includes MDBs in debt restructuring but quantifies the benefit in case (a).

JEL-Codes: H630, E620.

Keywords: concessional loan, debt restructuring, haircut, multilateral development banks.

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June 19, 2023

I thank Dotse Tsikata for drawing my attention to the preferred creditor status of multilateral development banks and Ishac Diwan for drawing my attention to related work.

## 1. Introduction

The loans of the IMF, World Bank, and other multilateral development banks are excluded from debt restructuring. MDBs are given priority for repayment of debt in the event of a borrower experiencing financial distress. This is the result of their preferred creditor status.<sup>1</sup> Proponents of this arrangement argue that it is necessary because MDBs give loans at concessional interest rates<sup>2</sup> and they are the only creditors that lend to debt-distressed countries. China and other creditors have challenged the preferred creditor status of multilateral lenders and called for the inclusion of their loans in debt restructuring (Cordella and Powell, 2021; Diwan et al, 2023; Kebret and Ryder, 2023).

The preferred creditor status of MDBs is not generally stated in legal contracts. It is a market convention or practice that is not backed by any contractual clause or international law. Yeyati (2009) argues that a debtor may give MDBs a preferred creditor status in expectation that MDBs will extend credit during a crisis.

A group of creditors lent money to an entity. Some of them (the IMF, World Bank) chose to lend at a concessional interest rate. That was their choice. If the debtor is in financial distress, one may understand not why a creditor would claim that it deserves priority or a preferred creditor status because it was a good Samaritan (gave out its loan at a concessional interest rate).

In this note, I argue that the value of the concessional lending of MDBs should be quantified and included in debt restructuring with MDBs as participants.

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<sup>1</sup>This is not generally stated in legal contracts. It is a market convention or practice that is not backed by any contractual clause or international law.

<sup>2</sup>The International Development Association (IDA) is the concessional lending arm of the World Bank. It is a major lender to the world's poorest countries.

## 2. A conceptual framework

Consider a country in debt distress that has applied to the IMF for financial assistance (e.g., extended credit facility) and needs to restructure its debt. As part of the debt-restructuring negotiations, the IMF and other MDBs, in effect, tell all creditors that "Country Y cannot service its debt. The IMF and other MDBs are willing to give the country a loan and also supervise the country to implement policies that will boost its revenue, cut expenditure, and ensure that its debt is sustainable. This will ensure (or increase the probability) that the country can service its debts, subject to non-MDB debts being restructured."

Clearly, the MDBs (including the IMF) will render a service that will benefit all creditors. Baqir, Diwan, and Rodrik (2023) made a similar point by noting that:

*“The presence of the (debt) overhang therefore necessitates a three-sided bargain: The debtor government can afford to undertake adjustment policies – i.e., invest in growth opportunities that pay in the future -- only if additional resources are provided. The IFIs<sup>3</sup> can safely lend those resources only if the old creditors undertake debt (and debt-service) reduction. The old creditors, in turn, will provide debt reduction only if the IFIs can apply effective conditionality to debtor governments to ensure appropriate growth policies are in place. **The gains that such a package unleashes can be shared among all parties involved.**”* (Parenthesis and bold font mine)

Let the benefit of the service by the IMF and MDBs to the non-MDB creditors be  $\$X$ . *In what follows, the key point is that the MDBs will be included in debt restructuring and the non-MDB creditors will pay  $\$X$  as an **additional haircut loss.***

The debt restructuring process will work as follows: restructure all debt (including multilateral debt). No lender enjoys a preferred creditor status. For each creditor, compute the present value of its restructured debt (the stream of restructured interest and principal payments) under an IMF program. Call it  $PV_{imf}$ . For each creditor, compute the present value of

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<sup>3</sup>IFIs refers to International Financial Institutions (the IMF and MDBs).

its debt if the IMF does not intervene (i.e., the status quo, without an IMF program). Call it  $PV_o$ .<sup>4</sup> The difference,  $PV_{imf}$  minus  $PV_o$ , is the benefit of the IMF's program (service) to each creditor. It is the difference between the present value of restructured debt with an IMF program and the present value of debt without an IMF program. Now add  $PV_{imf} - PV_o$  for all creditors (except the MDBs). This is the benefit/value to all creditors (except the MDBs) of the MDB's **new** loans to the debt-distressed country. This is  $X$ .<sup>5</sup>

As an example, consider two creditors. A debt-distressed country (the debtor) owes creditor 1 an amount of \$600 (with no grants) and creditor 2 (an MDB) an amount of \$400, with a 25% non-payable grant component equal to  $\$0.25(400) = \$100$ . Thus, the country owes creditor 2 an amount of  $\$400 - \$100 = \$300$ . Suppose a debt relief of  $R = \$300$  is required to make the country's (debtor) debt sustainable. We may say that this is a haircut of  $\$300/\$1000 = 30\%$ . Under the conventional method with uniform or comparable treatment,<sup>6</sup> creditor 1 will incur a haircut loss of  $\$0.3(600) = \$180$  and creditor 2's loss will be  $\$0.3(400) = \$120$ .<sup>7</sup>

In my approach, I do not consider the concessionality of the MBD's loan. I ignore the **non-payable** grant component of \$100 and take  $\$600 + \$300 = \$900$  as the total stock of debt. Creditor 1 (the non-MDB creditor) can pay the  $\$X$  through a haircut loss in two ways: **before** the

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<sup>4</sup> $PV_o$  may be estimated by using, among others (e.g., the ability of the creditor to enforce the payment obligation of an “insolvent” debtor), the price of the debt in the secondary market before the debtor (country) asked the IMF/MDBs for assistance.

<sup>5</sup>Suppose  $R$  is the required debt relief, and  $C$  is the set of non-MDB creditors. Then  $X = \sum_{j \in C} (PV_{imf} - PV_o)$ . We may write  $X = \sum_{j \in C} (FV - R - PV_o)$ , where  $FV$  is the face value of the debt.

<sup>6</sup>See, for example, the discussion on the “comparability of treatment” in Diwan et al (2023) and Rivetti (2022).

<sup>7</sup>Suppose that, in general, creditor  $j$ 's loan is  $D_j$  and the total debt relief is  $R$ ,  $j = 1, 2$ . Creditor  $j$ 's haircut loss is  $h_j = \frac{R}{D_1 + D_2} D_j = \frac{D_j}{D_1 + D_2} R$ . In the example, above  $\frac{R}{D_1 + D_2} = 30\%$ . Losses are proportional to the distribution of debt across creditors. Creditor  $j$  accounts for a proportion,  $\frac{D_j}{D_1 + D_2}$ , of total debt and incurs a haircut loss which is a proportion,  $\frac{D_j}{D_1 + D_2}$ , of the debt relief,  $R$ . That is,  $h_j = \frac{D_j}{D_1 + D_2} R$ .

MDB (creditor 2) incurs haircut loss or **after** the MDB incurs the haircut loss. I consider both cases.

**Method 1:** Creditor 1 incurs an **initial** haircut loss of  $\$X$ . If  $X < 300$ , then both creditors will share the burden of the remaining debt relief of  $\$(300 - X)$ . Applying a discount (percentage haircut) of  $(300 - X)/900$  on each creditor's loan will make up for the shortfall of  $\$(300 - X)$  and give a total debt relief of  $\$300$ . If  $X \geq 300$ , then creditor 2 incurs no haircut loss. The debt relief of  $\$300$  is entirely borne by creditor 1.

**Method 2:** Creditor 1 pays  $\$X$  through a haircut loss **after** the MDB incurs an **initial** haircut loss. The debt relief of  $\$300$ , given a total debt of  $\$900$ , will require a haircut of  $1/3$  on each creditor. Thus, the initial haircut loss for the MDB (i.e., creditor 2) will be  $\$(1/3)(300) = \$90$  and creditor 1's loss will be  $\$(1/3)(600) = \$180$  for a total debt relief of  $\$270$ . If  $\$X$  is at least equal to  $\$30$ , creditor 1 will incur an additional haircut loss of  $\$30$ , which brings the total debt relief to  $\$270 + \$30 = \$300$ . If  $\$X$  is less than  $\$30$ , then creditor 1 will pay  $\$X$ , leaving a shortfall of  $\$(30 - X)$ . Applying a discount (percentage haircut) of  $(30 - X)/900$  on each creditor's loan will make up for the shortfall of  $\$(30 - X)$ .

Creditor 2 incurs a bigger loss under method 1 than it does under method 2. This is not surprising because creditor 2's haircut is applied at a later stage in method 1 than in method 2. The proof is simple. Under method 1, creditor 2 incurs a positive loss or no loss depending on whether  $X$  is greater than or smaller than 300. We may write the size of this loss (in dollars) as

$\hat{h}_2 = \max \left[ 0, \frac{300-X}{900} 300 \right]$ . Similarly, under method 2, the size of creditor 2's loss is

$\tilde{h}_2 = \max \left[ 90, 90 + \frac{30-X}{900} 300 \right]$ . Suppose  $0 \leq X \leq 30$ . Then  $\tilde{h}_2 = 90 + \frac{30-X}{900} 300 = \hat{h}_2 =$

$\frac{300-X}{900} 300$ . If  $30 < X < 300$ , then  $\tilde{h}_2 = 90 > \hat{h}_2 = \frac{300-X}{900} 300$ . If  $X \geq 300$ , then  $\tilde{h}_2 = 90 > \hat{h}_2 =$



0. In general, if  $X$  is sufficiently small (e.g.,  $0 \leq X \leq 30$  in this example), there is no difference between method 1 and method 2 in terms of creditor 2's haircut loss. Otherwise, creditor 2 incurs a bigger haircut loss in method 2.

### 3. The approach of Diwan, Harnoys-Vannier, and Kessler (2023)

As mentioned above, there are two justifications for the preferred creditor status of MDBs: (a) they give concessional loans, and (b) they give loans to debt-distressed countries when other lenders would not. My approach considers the case in (b). In a recent paper, Diwan, Harnoys-Vannier, and Kessler (2023) consider the case in (a) by explicitly including the degree of concessionality of loans in debt restructuring. Diwan, Harnoys-Vannier, and Kessler (hereafter DHK) discarded the preferred creditor status of the MDBs (i.e., included them in debt restructuring) and quantified the benefit/value of their **previous** concessional loans to determine the haircut they should take.

In terms of the concessionality of loans, the current debt restructuring arrangement treats all non-MDB lenders as a homogeneous group. But they are not. According to a February 2023 article by Etsehiwot Kebret and Hannah Ryder in *The Diplomat*:

*"An analysis of 157 countries comparing World Bank to Chinese lending in the 2000-2014 period found that while Chinese lending terms were less concessional than those for World Bank projects, Chinese loan terms were more concessional than private sector terms. The authors also found that loans from Chinese institutions tended to be larger than those from the World Bank (the average loan sizes were \$307 million and \$148 million, respectively), while 30 countries were able to get loans from China but not the World Bank, which may explain the difference in costs."*

For **all** creditors, DHK (2023) calculated the grant (or concessional) element of their loans. This is "... the difference between the loan's nominal value (face value) and the sum of the discounted future debt-service payments to be made by the borrower (present value), expressed as a percentage of the loan's face value." As they correctly observed, "Whenever the

interest rate charged for a loan is lower than the discount rate, **the present value of the debt is smaller than its face value**, with the difference reflecting the (positive) grant element of the loan."

To illustrate DHK's approach, let's return to the numerical example in section 2. Under their method, the degree of concessionality is taken into account and must be equalized across creditors as much as possible. Given that creditor 2 has a grant component of 25%, creditor 1 should have a grant component (concessionality) of at least 25%. Twenty-five percent of \$600 is \$150. So, after equalizing the concessionality of loans, creditor 1 suffers a haircut loss of \$150. But the total debt relief required is \$300. We have to determine how to split the remaining debt relief of \$150 between creditors 1 and 2. Applying a 15% discount to creditor 1's loan of \$600 and creditor 2's loan of \$400 gives additional debt reliefs of \$90 and \$60 respectively for a total additional debt relief of \$150. In total, creditor 1 incurs a haircut loss of  $\$150 + \$90 = \$240$  and creditor 2 incurs a haircut loss of  $\$60 + \$100 = \$160$ , where we have taken account of the \$100 grant component of creditor 2's loan as an **advance** on debt reduction. Note that  $\$240/\$600 = \$160/\$400 = 40\%$ . That is, after debt restructuring, DHK's method equalizes the levels of concessionality for both creditors.<sup>8</sup>

Equalization of concessionality levels may not hold in all cases. Imagine that the total debt relief is small, the non-concessional creditor (creditor 1) accounts for a very large percentage of total debt, and creditor 2's loan has a high level of concessionality. Then, it is

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<sup>8</sup>The numerical example in this paper with two creditors gives the gist of DHK's approach. With more than two creditors, the debt restructuring also follows a sequential or staggered process (see the annex of DHK's paper). The creditor with the smallest level of concessionality has to increase its concessionability and, **if necessary**, to the level of the creditor with the second smallest concessionality. If that covers the requisite debt relief, then the process ends. If not, the creditor with the second smallest concessionality joins the process and so on.

possible that that an increase in creditor 1's concessionality level --- but below the level of creditor 2 --- covers the entire debt relief.

In general, creditors with a higher degree of concessional loans suffer smaller haircuts. In DHK's computations, the lowest haircuts are suffered by MDBs, followed by bilateral donors like China, and then private creditors. Private creditors incur the largest haircut losses because their loans have the smallest degree of concessionality.

After their calculations, DHK (2023) asked "How should MDBs contribute to these deals?". They opined that:

***"The most straightforward interpretation of our calculation would be to accept a haircut but as described above, this goes against practice and possibly the ability of IDA of remaining a major contributor to development. Those financial contributions could also be delivered in the form of new additional flows. The communiqué of the Global Sovereign Debt Roundtable held in April 2023 suggested that this could be a possible consensus among global players, and our approach provides a possible yardstick to estimate the magnitude of those new flows. Instead of haircuts, those new flows could be provided in the following way: over three years, IDA would, in addition to its allocation, offer new concessional credit equivalent (in present value) to the amount of losses it needs to bear."***

#### **4. Discussion and conclusion**

In this note, I have discussed how the loans of MDBs may be included in debt restructuring while taking account of two arguments in favor of granting MDBs a preferred creditor status. I did not consider a third argument, which is that without their preferred creditor status, MDBs cannot raise money at low interest rates. This argument is sensible if countries get into debt distress as a result of **only** factors that are beyond their control (i.e., exogenous factors).<sup>9</sup> To the extent that debt crises are also partly caused by fiscal and macroeconomic mismanagement, inefficiencies, and corruption, one may argue that the preferred creditor status

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<sup>9</sup>Cordella and Powell (2021) provide a justification for the preferred creditor status of MDBs within a formal microeconomic model. They assume that debt crises are the result of only exogenous factors.

of MDBs leads to moral hazard behavior in debtor countries because MDBs lend too much to countries that are not fiscally responsible. Without their preferred creditor status, MDBs will lend more responsibly and this will induce poor countries to be fiscally responsible.

On the preceding point, Diwan, Kessler, and Properzi (2023) show that the World Bank's lending --- through its concessional arm (the IDA) --- is inefficient because the IDA has been forced to increasingly switch from loans to grants resulting in a reduction in its debt service refloes. Furthermore, the support from the IDA has become less effective because it leaks more into debt service to other creditors.

It is also not obvious, at least in theory, that without the preferred creditor status of MDBs, average interest rates on loans to poor countries will increase. This may increase the interest rates of MDBs but it may reduce the interest rates of non-MDB creditors because the inclusion of MDBs in debt structuring will reduce the size of the haircuts of non-MDB creditors in the event of debt restructuring and so non-MDB creditors may reduce their estimates of the size of expected losses.

In addition, Kebret and Ryder (2023) observed that, in the late 2000s, the World Bank, the IMF, and the AfDB relieved \$26.7 billion in debt and between 1970 and 2021, the World Bank relieved at least \$38.4 billion in debt to African countries without affecting their capacity to raise money or lend to debt-distressed countries.<sup>10</sup>

If one believes that the withdrawal of preferred creditor status will adversely affect the capacity of MDBs to lend in a time of crisis, then to the extent that  $X$  is affected by the size of MDBs' loans, one may argue that  $X$  is affected by the inclusion of MDBs in debt restructuring.

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<sup>10</sup>According to Kebret and Ryder (2023), "... a recent independent report commissioned by the G-20, and led by Tanzanian consultant Frannie Léautier, who previously worked at very senior levels at the World Bank and AfDB, found that 15 MDBs, 10 of which have AAA ratings, have a significant potential to reduce risk aversion and ease capital requirements, without losing these ratings."

Therefore,  $X$  cannot be determined independently of debt restructuring. However, as noted above, MDBs have been involved in significant debt forgiveness or debt relief deals without affecting their capacity to raise money or lend to debt-distressed countries. Without a compelling market-failure argument and on the basis of the aforementioned observation by Diwan, Kessler, and Properzi (2023), what may be more important is efficient lending by MDBs.

Finally, my approach and the approach in DHK (2023) could be combined. Method 1 in my approach can be applied and then the method in DHK (2023) will follow.

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