CASE STUDY

Helping Colombia reduce the risk of interest rate increases in their IBRD debt portfolio by 99 percent

The World Bank helped Colombia protect USD 10.7 billion against interest rate increases by using the conversion feature of the IBRD Flexible Loan (IFL).

During 2019-2021, Colombia implemented 34 interest-rate conversions that reduced the floating rate exposure of their IBRD portfolio by 99.4 percent. The conversions contributed to Colombia's overall threefold interest rate risk reduction (from 12.2 percent in 2018 to 3.6 percent in April 2021) in their total debt portfolio and immunized the budget against potential reference rate hikes. Conversions were very cost-effective by fixing rates in historically low levels and avoiding costly derivative contracts with market counterparts.

Background

Debt financing is an essential tool for Colombia to fund critical development objectives, such as quality education, clean energy, and infrastructure. The central government has a total of USD 178 billion in debt, about 67 percent of GDP (April 2021).

A sophisticated borrower in the financial markets, Colombia put a stronger focus on financial risk management over the last decade.

To mitigate risk in their debt portfolio, the Colombian government developed a debt management strategy. The government defines its cost-risk preferences in the strategy, and a high-level Treasury Committee (chaired by the Minister of Finance, with vice ministers and directors-general also in attendance) approves financial risk management operations. Both mechanisms – the strategy and the committee – ensure a robust governance process to manage the debt portfolio.

As a regular World Bank borrower, with IBRD loans totaling USD 11.7 billion (April 2021), Colombia wanted to benefit from the historically low-interest-rate environment. In line with the cost-risk benchmarks prescribed in their debt management strategy, they wanted to decrease the exposure to floating rate debt on its IBRD loans and fixed rates cost-effectively.

Additionally, Colombia wanted to increase its fiscal resilience against any uncertainty the global transition

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away from LIBOR (the London Interbank Offered Rate - the most commonly used benchmark reference rate in the global financial markets) might bring about.

Debt Management Objectives

- Reduce interest-rate risk of the debt portfolio.
- Eliminate uncertainty around the LIBOR transition.
- Benefit from the historically low-interest-rate environment.

IBRD Financial Solution

The IBRD Flexible Loan (IFL) includes options to manage interest rate risks over the life of the loan. These options are embedded in the loan agreement and can be executed at a borrower's request at any time. Provisions in the loan agreement allow the borrower to fix the reference interest rate of all or part of the disbursed and outstanding balance of an IBRD loan. Borrowers can establish a pre-specified schedule of rate fixings (e.g., on each interest payment date, annually, or 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.

In the case of Colombia, the client requested a series of 34 ad-hoc conversions, totaling USD 10.7 billion, to fix the interest rate on their IBRD loans (2019 - April 2021).

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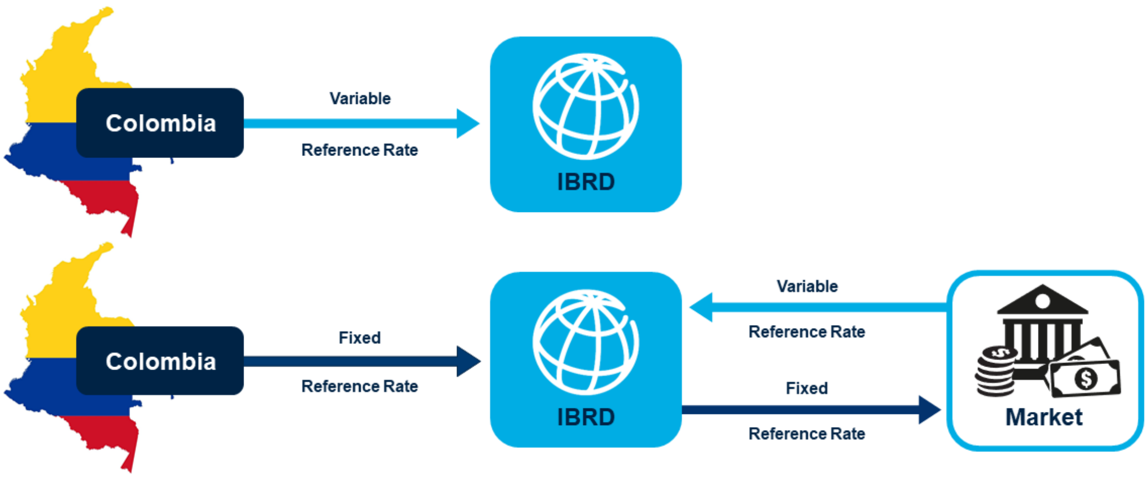
CASE STUDY

Transaction Structure

Time Period: 2019-2021, Number of Conversions: 34, Total Amount: $10.7 Billion



World Bank Treasury's Role

- From 2019 to April 2021, the IBRD converted 34 loans with a total of USD 10.7 billion from variable reference to fixed interest rate.
- Leveraging its triple-A credit rating, the IBRD provided Colombia with improved market access and competitive financing terms.
- The IBRD made the conversion administratively cost-effective and straightforward for Colombia as an embedded feature of the IFL agreement.
- IBRD's conversions also avoided Colombia's exposure to counterparty risk and did not require collateral or charge additional fees in lieu of collateral.

Outcome

Over 28 months, Colombia's floating rate IBRD loans decreased from USD 7.7 billion (2018) to 5 million (April 2021). It contributed to a significant reduction in the floating rate share of the country's debt portfolio (from 12.2 percent in 2018 to 3.6 percent in April 2021), as Colombia also fixed its loan portfolio with other multilateral financial institutions.

Although interest rates have been low over the last five years, historically, they are quite volatile. Colombia insulated itself from this volatility by using the interest rate conversion feature of the IFL. They benefitted from USD 10.7 billion financial protection, which could translate into around USD 100 million in potential savings per year from every one percent unexpected increase in the LIBOR. Unforeseen increases in interest rates would immediately impact the budget and force the government to cut other priority expenditures.

Historical 6M LIBOR (1985 – 2021)

Other risk management solutions from IBRD

Interest rate conversions are among the many ways the World Bank Group helps member countries become more resilient to economic shocks. IBRD provides multiple [Financial Risk Management] solutions to help clients.

IBRD's triple-A credit rating, market presence, and convening power allow the World Bank Treasury team to develop innovative new products to help clients maximize financing and mitigate risk.

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