

## Credit Analysis Report

International Finance Facility for  
Immunisation

## Ratings

**International Finance Facility for  
Immunisation**

Long-term IDR*	AAA
Short-term IDR*	F1+
Outlook	Stable

\* IDR – Issuer Default Rating

## Analysts

## Sovereign Analyst

Brian Coulton  
+44 20 7862 4097  
brian.coulton@fitchratings.com

## ABS Analyst

Joanne Wong, CFA  
+44 20 7417 4312  
joanne.wong@fitchratings.com

## Supranationals Analyst

Eric Paget Blanc  
+ 33 1 44 29 91 33  
eric.pagetblanc@fitchratings.com

## David Riley

+ 44 20 7417 6338  
david.riley@fitchratings.com

## ■ Rating Rationale

The International Finance Facility for Immunisation (“IFFIm”) is a new multilateral development financing institution. Its purpose is to finance vaccination programmes in 70 low-income countries via the Global Alliance for Vaccines and Immunization (“GAVI”) by borrowing from international capital markets. IFFIm’s financial base consists of legally binding grants from sovereign donors, currently the governments of France, Italy, Norway, Spain, Sweden and the UK.

IFFIm’s ‘AAA’ rating reflects the strong financial and political support from its donor governments and its adherence to prudent limits on borrowing to reflect its exposure to sovereign credit risks in the vaccine recipient countries. All of the sovereign donors are rated ‘AAA’ by Fitch with the exception of Italy, which has an ‘AA’ rating and is on Rating Watch Negative.

Donor governments have entered into legally binding commitments to make grants to IFFIm that will be financed from national budgets and hence are of comparable credit quality to the donor governments’ other financial obligations, including public debt. As such IFFIm’s issuer rating is directly linked to the rating of the UK, rated ‘AAA’, which is currently the largest sovereign donor contributor to IFFIm. In the unlikely event of a downgrade of the UK sovereign rating, IFFIm’s rating will also be downgraded to take account of the lower credit quality of the UK’s future commitments. If France increases its contribution as planned, IFFIm’s credit rating will also likely be linked to the sovereign rating of France.

The size of sovereign donors’ grant commitments will be reduced if any of the 70 IFFIm recipient countries enter protracted arrears on their debt obligations to the International Monetary Fund (“IMF”). Fitch has used its CDO VECTOR model to determine the maximum permissible level of borrowing relative to the net present value of grant commitments – the “gearing ratio” – to reflect the risk of recipient countries incurring arrears to the IMF. IFFIm must not exceed a gearing ratio of 73% if it wishes to retain its ‘AAA’ rating. As well as factoring in the risk of IMF arrears among IFFIm recipients, the maximum gearing ratio also incorporates a reducing adjustment for the non-‘AAA’ status of Italy’s pledged donations.

## ■ Credit Highlights

- A key credit judgement underpinning IFFIm’s ‘AAA’ rating relates to the commitment of its sovereign donors to honour their obligations under their respective grant agreements. The legal underpinnings of the grant agreements enhance the credibility of donors’ commitments and mitigate the political risk that successor governments could decide to renege on the commitments.
- Fitch’s judgement on the credit quality of IFFIm’s asset base is ultimately based on its view of donor sovereigns’ commitment to IFFIm and GAVI’s development goals and the significant reputational costs to donors of breaching their obligations, rather than donor fears of legal sanction.

- IFFIm's maximum "gearing ratio" (the prudential limit on its borrowing relative to the present value of donor commitments) consistent with retaining its 'AAA' status is 73% and is based on the grant payments committed by the initial six donor countries. Grant payments are legally binding and unconditional, but the scheduled amount may be reduced if recipient countries enter into protracted arrears with the IMF.
- The risk of developing countries entering arrears to the IMF is lower than that of wider sovereign default, reflecting the IMF's preferred creditor status. Taking this into account, the weighted average rating of IFFIm recipient countries is 'BB'.
- All of the donor countries are rated 'AAA' with the exception Italy which is 'AA' and is on Rating Watch Negative. The gearing ratio is reduced further to take into account the lower rating of Italy.
- IFFIm's 'AAA' rating is directly tied to that of the largest donor, currently the UK government, which has committed approximately USD2.6bn accounting for 65% of total commitments. A downgrade of the UK sovereign rating would result in a downgrade of IFFIm's rating as in Fitch's opinion, IFFIm would be unable to cut its gearing ratio sufficiently to take account of the lower credit quality of the UK's outstanding commitments. If France increases its contribution as planned, IFFIm's credit rating will also be linked to that of the sovereign rating of France.
- IFFIm has appointed the World Bank (rated 'AAA') to act as its treasury manager responsible for managing IFFIm's funding, liquidity and other treasury operations in a manner consistent with IFFIm retaining its 'AAA' rating. Fitch takes comfort from the appointment of a highly experienced and 'AAA' rated institution as treasury manager. Moreover, the World Bank's close association with IFFIm implies that it, like donor governments, will be motivated to ensure the successful operation of IFFIm.
- IFFIm will issue unsubordinated and unsecured notes to raise funds to finance GAVI immunisation programmes. The total amount of notes outstanding at any time will be monitored by the treasury manager to ensure compliance with the maximum gearing ratio. A wide range of notes, including fixed rated notes, floating

rated notes, zero coupon notes, dual currency notes and index-linked notes may be issued by IFFIm. All notes issued are ranked *pari passu* among themselves.

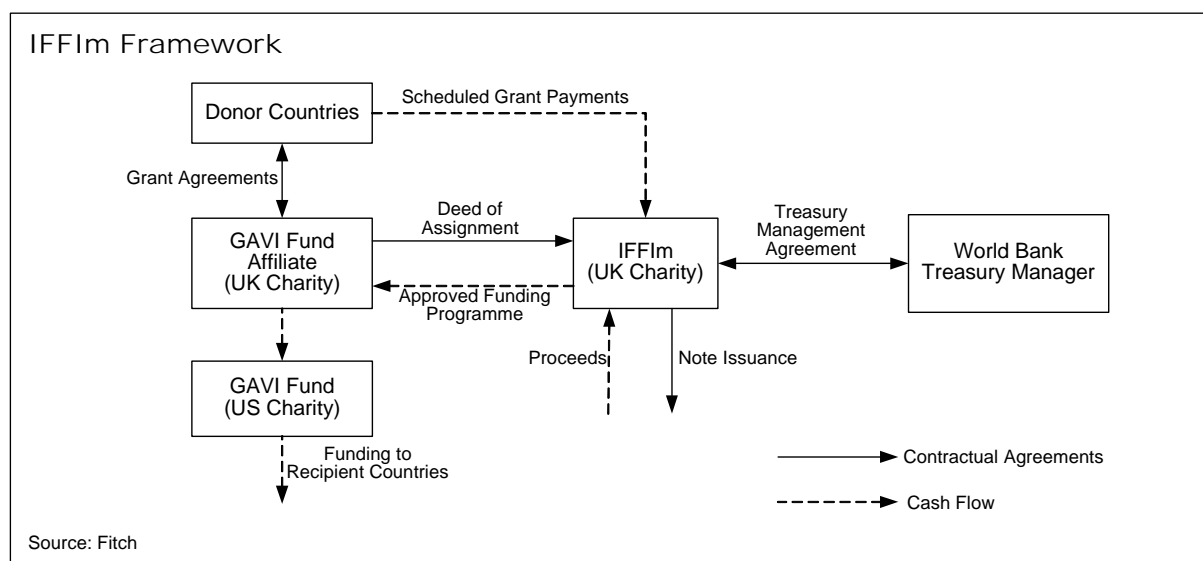
In assigning a credit rating to IFFIm, Fitch has incorporated aspects of its supranational, sovereign and structured finance rating approaches. CDO modelling techniques used in structured finance ("SF") analysis have been utilised to gauge the risks of a breach in the IMF arrears condition among the "virtual" portfolio of recipient countries. Fitch has also drawn on its multilateral development bank ("MDB") methodology in its analysis of sovereign support for IFFIm. Furthermore, in its assessment of the risk of recipient country arrears to the IMF, Fitch has applied an uplift to sovereign ratings to reflect the IMF's 'preferred creditor' status, drawing directly on its approach used to assess risk in MDB loan portfolios.

Fitch has assigned an Issuer Default Rating to IFFIm as a borrowing entity and counterparty and will be assigning issue ratings to individual tranches of its medium-term note programme and any other debt securities it may issue.

#### ■ What is IFFIm?

IFFIm is a new multilateral development financing institution supported by sovereign donors. Its objective is to facilitate the accelerated financing of large-scale immunisation programmes in 70 developing countries by issuing debt in the international capital markets backed by multi-year grant pledges from sovereign donor governments. IFFIm anticipates raising funds of USD4bn in total over the next 10 years which is expected to prevent five million child deaths before 2015 and more than five million future adult deaths. The sovereign governments of Brazil, France, Italy, Norway, Spain, Sweden, South Africa and the UK have made commitments to IFFIm but at this stage only France, Italy, Norway, Spain, Sweden and the UK have made formal multi-year grant pledges which comprise IFFIm's asset base. Funds raised by IFFIm will be disbursed through GAVI – a global health partnership committed to improving access to immunisation for children in impoverished countries, which comprises governments in industrialised and developing countries, UNICEF, the WHO, the World Bank, the Bill & Melinda Gates Foundation, non-government organisations, vaccine manufacturers and public health and research institutions.

While IFFIm is incorporated in the UK as a private limited company with charity status, IFFIm's development policy role and the joint participation of several sovereign governments as its stakeholders



render it closest to a supranational in terms of its status as a rated entity. From a credit perspective, strong parallels exist with the MDBs rated by Fitch. For example, Fitch’s judgments on the high credit quality of the MDBs are based, first and foremost, on the support they receive from the sovereign member governments in the form of ‘callable’ capital which can be drawn upon in the event of financial distress. The commitments by donor governments to IFFIm are arguably more secure than MDBs’ ‘callable’ capital, to the extent that they are expected to be made in contrast to ‘callable’ capital which is only triggered in the event of financial distress – an extremely rare event for the MDBs. Nonetheless, sovereign donor pledges to IFFIm will not be treated as government debt<sup>1</sup>, reflecting the conditionality attached to the amount of donor countries’ commitments, which implies a genuine transfer of risk from governments to IFFIm (and its creditors). Ultimately, the ‘AAA’ credit rating assigned to IFFIm is based on similar judgments about support from participating sovereigns as applied to the MDBs, which reflect reputational risk considerations. The European Banking Committee of the European Commission has agreed in principle that IFFIm should be included in the EU Directive’s list of MDBs.

The major distinction between IFFIm and other supranationals, however, relates to its narrow focus as a financing vehicle – its sole function will be to raise funds on the back of the grant pledges and pass them to GAVI to finance immunisation. It has no assets or liabilities other than those associated with this function. In this sense, it is similar to a special-purpose vehicle (“SPV”) of the type seen in SF transactions. Since IFFIm is the beneficiary of the

sovereign donor grants agreements it does indeed share parallels with typical SPVs, which issue notes backed by a specific pool of assets which the SPV owns. However, in IFFIm’s case, the assets are the multi-year grant pledges rather than real or financial assets clearly separated from the “originator”.

In recognition of IFFIm’s unique nature, Fitch has combined its supranational, sovereign and CDO criteria in its assessment.

■ Financial Structure of IFFIm

The asset base of IFFIm consists of committed payment obligations from sovereign countries including the UK (‘AAA’), France (‘AAA’), Italy (‘AA’, Rating Watch Negative), Norway (‘AAA’), Spain (‘AAA’) and Sweden (‘AAA’) over the next 20 years. Each of the sovereign donor countries has entered into a grant agreement with the GAVI Fund Affiliate, the initial beneficiary of the grants, which has, in turn, assigned its rights under the grant agreements to IFFIm. Under the grant agreement, the donor countries undertake to pay the GAVI Fund Affiliate scheduled grant payments, as set out in the agreement. Notes will be issued by IFFIm to bridge the timing gap between approved vaccination programmes and the receipt of payments from the donor countries.

The total amount of debt issued by IFFIm will be limited by the gearing ratio, relating to debt outstanding as a proportion of the NPV of future donor grant flows.

The annual issuance amount, form and duration of the instruments will depend on the funding needs in the recipient countries.

<sup>1</sup> Eurostat has confirmed this treatment of IFFIm obligations.

All the issued bonds will rank pari passu and will be backed by the same pool of assets, i.e. scheduled grant payments from the donor countries.

The legal obligation flows are shown in the IFFIm Framework chart on page 3.

■ Operation of IFFIm

IFFIm will outsource its operational and financial management activities to GAVI and the World Bank ('AAA') respectively. The outsourced activities of IFFIm will be supervised by the IFFIm board. The GAVI Fund acts as the secretariat and is responsible for IFFIm's general administration.

Operational Management

GAVI was launched in 2000 to fight declining immunisation rates and the growing disparity in access to vaccines among the world's poorest countries. The GAVI partners created a vaccine fund to provide long-term financing to strengthen health systems in developing countries. Since its inception, GAVI has successfully committed over USD1.4bn to over 70 poor countries. GAVI is responsible for reviewing and approving grant requests from eligible recipient countries for the specified immunisation programmes. IFFIm will transfer the funds needed for GAVI-approved immunisation programmes following IFFIm's approval of each immunisation program and its receipt from GAVI Fund Affiliate of a disbursement request.

Financial Management

IFFIm has appointed the World Bank as its treasury manager. The expertise, experience and exceptional credit quality of the World Bank provides comfort that the financial management of IFFIm will be consistent with its 'AAA' rating. The scope of treasury services include funding operations, derivative transactions, donor and payment tracking, liquidity and investment management, risk monitoring, asset and liability management, accounting and reporting.

To protect its financial position and preserve its 'AAA' rating, IFFIm will limit its funding for new immunisation programmes to ensure that the maximum permitted gearing ratio is not breached. In addition to monitoring the gearing ratio, the World Bank will also manage liquidity to ensure that it is adequate to meet all payment obligations including to noteholders.

Grants are denominated in the currency of the respective donor country (with the exception of Norway, in USD) while the operating currency of IFFIm is USD. To mitigate currency risk, all cash

inflows will be swapped into USD to minimise the currency risk.

IFFIm may accept grant payments from new donor countries in the future. The treasury manager will monitor its borrowing capacity to ensure that the 'AAA' rating of IFFIm is preserved if new donor countries become involved. The gearing ratio may be adjusted when new donor countries join IFFIm in the future, depending on the credit quality of the new sovereign donors. Rating confirmation is required in case of any change to the credit quality of donor countries and the inclusion of new non-'AAA' donor countries.

■ Vaccine Programme Approval and Financing Process

Existing GAVI structures and processes will be used for IFFIm funding. The application process is as described below.

1. Eligible countries prepare applications to GAVI.
2. Applications, which must comply with GAVI's strategic objectives and general funding principles, are reviewed and evaluated by the independent review committee, which makes recommendations to GAVI's board.
3. The GAVI board reviews the applications and issues GAVI programme approvals to the GAVI Fund.
4. The GAVI Fund reviews the applications for funding and determines whether they will be funded via IFFIm or not.
5. If it is decided to fund via IFFIm, GAVI submits an application to the GAVI Fund Affiliate.
6. The GAVI Fund Affiliate considers whether to approve the funding application based on adherence to the appropriate documentation and its own funding policies.
7. The GAVI Fund Affiliate will then submit the application to IFFIm.
8. IFFIm considers whether to approve the application based on, inter alia, the implications for IFFIm's gearing ratio.
9. IFFIm will issue debt and transfer the proceeds to the GAVI Fund Affiliate.

■ Credit Analysis

Fitch adopts a two-step approach to determining the gearing ratio consistent with IFFIm being rated

'AAA'. Firstly, the agency uses its CDO VECTOR model to determine the probability of reductions in donations arising from recipient countries entering protracted arrears on their IMF debt. Secondly, the gearing ratio is further reduced to take into account the non-'AAA' rating of Italy. The outcome is a gearing ratio limit of 73%.

Grant Payments from Donor Countries

Date	UK (GBPm)	Italy (EURm)	Spain (EURm)	Sweden (SEKm)	Norway (USDm)	France (EURm)
2006	-	3.0	9.5	18.4	5.4	-
2007	9.4	6.0	9.5	18.4	5.4	20.0
2008	17.5	25.9	9.5	18.4	5.4	20.6
2009	25.8	25.8	9.5	18.4	5.4	21.3
2010	33.9	25.8	9.5	18.4	5.4	21.9
2011	42.1	25.8	9.5	18.4	-	22.6
2012	50.4	25.8	9.5	18.4	-	23.2
2013	58.8	25.8	9.5	18.4	-	23.9
2014	67.5	25.8	9.5	18.4	-	24.7
2015	76.6	25.8	9.5	18.4	-	25.4
2016	84.2	25.8	9.5	18.4	-	26.2
2017	90.8	25.8	9.5	18.4	-	26.9
2018	97.9	25.8	9.5	18.4	-	27.8
2019	105.6	25.8	9.5	18.4	-	28.6
2020	113.8	25.8	9.5	18.4	-	29.4
2021	122.6	25.8	9.5	-	-	30.3
2022	107.9	25.8	9.5	-	-	-
2023	90.4	25.8	9.5	-	-	-
2024	74.8	25.8	9.5	-	-	-
2025	61.3	25.8	9.5	-	-	-
2026	48.6	-	-	-	-	-
Total 2006-25	1,380	473	190	276	27	373
Total Equivalent at Exchange Rate of 23 Aug 2006 (USDm)	2,612	606	242	38	27	477

Source: World Bank

The detailed modelling assumptions and rationale are set out below. However a key prior question relates to whether the donor grant commitments – IFFIm’s asset base – are of comparable credit quality to that of the donor sovereigns themselves.

Donor Country Pledges – Sovereign Risk?

IFFIm’s future cash inflows consist of legally binding grants from sovereign countries that will be paid to IFFIm over the next 20 years to enable funding of GAVI immunisation programmes. At this stage donors have committed to extend the equivalent (at today’s exchange rates) of USD4 billion over the next 20 years. IFFIm’s objective is to raise additional funds sufficient to finance a total of USD4billion of immunisation programmes over the next 10 years (which will obviously require significantly more than USD4billion of grant commitments) but Fitch’s analysis is based only on the commitments made to date. The table above illustrates the profile of grant payments from each donor country denominated in original currency. The UK, which accounts for approximately 65% of total committed payments translated into USD, is the largest contributor. Italy ranks second, contributing about 15% of total grant payments. France aims to increase its contribution by around USD1bn in addition to the amount shown above, but this has not yet been approved and is not factored into Fitch’s analysis.

Since the grant payments from each donor will be made from national governments’ budgets, their credit quality is closely tied to that of the sovereign. However, though legally binding, IFFIm pledges are not linked in any formal way to donor’s traditional sovereign debt contracts. There is no sense in which a “default” on IFFIm pledges might effectively constitute an event of default on senior unsecured sovereign debt obligations. In addition, the grant payments will require the passage of annual budget legislation and hence annual parliamentary approval – for the UK for example, this procedure differs from that for traditional debt service<sup>2</sup>. In principle, this leaves the donor pledges to IFFIm exposed to political risk: a sovereign donor could, although remaining of ‘AAA’ credit quality, decide not to honour its IFFIm obligations. However, in Fitch’s judgment, this risk remains within the tolerances of a ‘AAA’ rating for the reasons discussed below.

First and foremost, Fitch judges there to be strong and durable political support for IFFIm and its development goals from the donors. Focusing particularly on the UK as the lead sponsor, commitment has come at the very highest levels of government and has been promoted by the UK in high profile international forums, including the G8

<sup>2</sup> UK government debt service is paid from the National Loans Fund which is authorised to make payments without annual parliamentary approval. IFFIm payments, like other government spending, would be subject to the parliamentary vote procedure, requiring the passage of the Annual Appropriations Act.

and the UN. The UK's support for IFFIm is broad based across the political spectrum as reflected in statements by current Conservative shadow ministers as well as by the former Conservative Party leader, Michael Howard:

*"There is also cross-party support for the international finance facility, including the IFF for immunisation."<sup>3</sup>*

All the participating governments view IFFIm as a key mechanism for supporting achievement of the United Nations Millennium Development Goals ("MDGs"), specifically MDG4 (reducing child mortality by two-thirds by 2025) and MDG6 (combating HIV/AIDS, malaria and other diseases).

All of the sovereign donors have entered into legally-binding contracts with IFFIm, a powerful signal of their policy intent and desire to credibly commit payment flows over the lifetime of future as well as current administrations.

With support for IFFIm having been laid out in such stark relief in legal as well as in political terms, Fitch judges that donors would face significant reputational costs if they were to renege on their commitments. The fact that IFFIm represents a high-profile international financial commitment would add to embarrassment as an individual sovereign donor's actions would have implications for the other participating sovereigns. Peer pressure among the IFFIm donors would be strong, as would pressure from supporters of IFFIm, including GAVI and the World Bank. Moreover IFFIm has the right to publicly announce any non-payment by the donors. The World Bank in particular would suffer a significant reputational shock, being very closely involved in IFFIm and could potentially hold significant financial exposure to IFFIm as a counterparty giving it a strong incentive to exert pressure on donors. International political pressure would be exacerbated by the adverse humanitarian implications, since non-payment of grants would affect disbursements for immunisation programmes.

From the perspective of the UK government, the lead sponsor of IFFIm, a failure to honour its obligations would have particularly adverse ramifications in terms of its relationship and reputation with co-sponsoring governments and the broader international community. Non-payment would also entail potentially damaging reputational losses with the wider investment community. From Fitch's perspective an IFFIm "default" would indeed send adverse signals about a sovereign's broader

willingness to pay and would be interpreted negatively from a credit perspective. For example, such an event would need to be factored into Fitch's ongoing rating assessment of UK sovereign-linked issues.

The legal contracts which underpin donor commitments to IFFIm would amplify reputation losses associated with an IFFIm default and make it more costly and complex for any donor to unilaterally withdraw its support. The IFFIm grant agreements have been signed by each participating donor government (for France, by Agence Française de Développement, rated 'AAA/F1+' by Fitch), and according to the transaction opinions, are legally binding and valid.

The obligation of each donor to make grant payments is expressed in the grant agreements as follows:

*"subject to clauses 2.2 and 2.3 the grantor irrevocably and unconditionally undertakes to pay the beneficiary the grant payments ...set out in the schedule."<sup>4</sup>*

The contracts also purport to waive sovereign immunity so that donors could, in principle, be taken to court by IFFIm for breach of contract in the event of a default and would be subject to the court's judgement. However whether IFFIm would have the financial resources or management incentives to take such action is not assured. Moreover, the legal commitments to IFFIm are more complex and potentially subject to greater dispute than those associated with standard sovereign bond contracts, generating uncertainty as to the success of any action against a government intent on not making payments to IFFIm. For these reasons, Fitch does not believe that the fear of legal sanction would, by itself, dissuade a donor that was determined to withdraw at any cost from its IFFIm commitments. Nevertheless, Fitch does view the legal agreements as enhancing the credibility of donors' commitments to IFFIm by raising the reputational costs of withdrawal.

In deciding whether to honour its IFFIm obligations, a sponsoring government would have to weigh up these potential reputational costs against the benefits of non-payment. In financial terms, the scale of the IFFIm commitments relative to overall public spending is relevant here. By way of illustration, the UK's IFFIm commitment in 2015, GBP77million,

<sup>3</sup> Hansard 11 July 2005

<sup>4</sup> Clauses 2.2 and 2.3 relate, respectively, to the high-level financing condition, a risk modelled by Fitch in its calculation of the gearing ratio, and to the early winding down of the programme once all outstanding obligations have been paid to IFFIm creditors.

Recipient Portfolio

Country (%)	Weighting	Total Share
Afghanistan, Angola, Armenia, Azerbaijan, Benin, Bhutan, Bolivia, Burkina Faso, Burundi, Cambodia, Cameroon, Central African Republic, Chad, Comoros, Congo, Republic of Cote d'Ivoire, Djibouti, Eritrea, Gambia, Georgia, Ghana, Guinea, Guinea-Bissau, Guyana, Haiti, Honduras, Kenya, Kiribati, Kyrgyzstan, Republic Lao PDR, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Moldova, Mongolia, Mozambique, Myanmar, Nepal, Nicaragua, Niger, Papua New Guinea, Rwanda, Sao Tome & Principe, Senegal, Sierra Leone, Solomon Islands, Somalia, Sri Lanka, Sudan, Tajikistan, Tanzania, Timor-Leste, Togo, Uganda, Ukraine, Uzbekistan, Yemen Rep, Zambia, Zimbabwe	1	62
Vietnam	3	3
Bangladesh, Congo DR, Ethiopia, India, Indonesia, Nigeria, Pakistan	5	35
<b>Total</b>		<b>100</b>

Source: World Bank

would probably be equivalent to just 0.01% of total public expenditure for that year. The annual savings benefits are therefore unlikely to be material for a 'AAA' rated sovereign.

Financial savings may not, of course, be the only issue if, for example, changes in government or political developments cause a major shift in policy priorities on international development. However, with wide political support for the UN MDGs and broad consensus on development policy in the donor countries, Fitch judges the risk that a new administration would choose to renege on its legal commitment to IFFIm as very small given the marginal financial savings and the reputational costs, including possibly the embarrassment of a court ruling that it had breached its legal obligations to IFFIm.

Potentially, a greater source of "political risk" would appear to be if IFFIm came to be perceived as ineffective or dysfunctional in terms of achieving broader development policy goals. For example, a donor country might conceivably re-consider its commitments if one or more of the recipient countries became a "rogue" state unworthy of ongoing support. This could occur without the recipient country breaching the high-level financing/good governance condition in terms of protracted arrears to the IMF. However, there is plenty of scope within the IFFIm framework to deal with such concerns through routes other than non-payment of grant obligations. The GAVI board could, for example, decide to cease disbursements to a particular country if requested by the sponsors. The flexibility afforded by the IFFIm disbursement framework would make it hard for any sponsor to argue that it had been forced into non-payment by political circumstances beyond its control. As such, non-payment would probably be interpreted as a "wilful" act.

Moreover, if a successor government were keen to withdraw from IFFIm commitments, there would be

some scope, at least in the earlier years of the programme, to do so in an orderly fashion without compromising IFFIm's credit standing. It would, in principle, be possible to wind down the disbursement programme and thus prevent the creation of any new IFFIm obligations after a certain point. The legal framework underpinning IFFIm allows this to happen under certain circumstances and ensures that ongoing grant payments will be sufficient to meet all outstanding financial obligations at the point when the programme is wound up. Obviously a key feature of IFFIm is its capacity to accelerate funding for immunisation and hence this exit option would therefore cease to be available relatively early in the lifespan of the programme.

Recipient Countries – Risk of IMF Arrears

The size of the commitments from donor countries is conditional on the recipient countries honouring their financial obligations to the IMF. If a recipient country enters into protracted arrears to the IMF (i.e., it fails to meet payments for a continuous period of six months), the grant due from the donor countries will be reduced by an amount calculated according to the predetermined weighting assigned to the recipient country concerned. The reduction in grant payment will have no relationship to the actual amount of funding extended to the recipient country. The list of approved recipient countries consists of 70 nations, most allocated a weighting of 1%. The exceptions to this are Vietnam at 3%, and Bangladesh, Congo DR, Ethiopia, India, Indonesia, Nigeria and Pakistan, all at 5%.

Fitch has assigned sovereign ratings to each of the recipient countries and has then applied a rating uplift of two to four notches to take into account the preferred creditor status of the IMF. The agency has given a four-notch uplift to countries that have never been in default to the IMF, consistent with recently published Fitch criteria on rating structured finance deals involving multilateral development bank

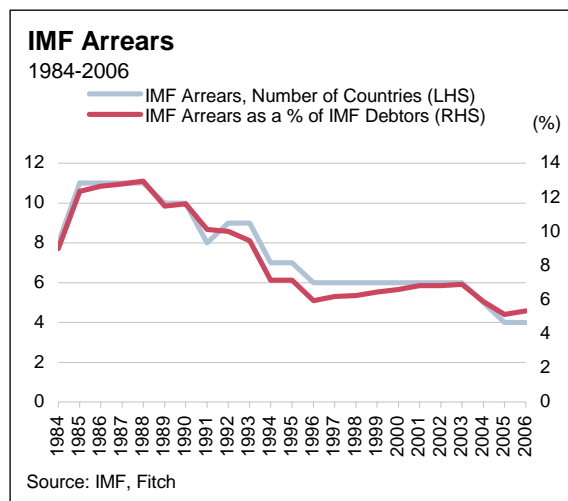
guarantees<sup>5</sup>. However, if a country has been in arrears within the last 10 years, the uplift is limited to two notches, while if it has been in arrears in the last 15 years but not within the last 10, it is assigned a three-notch uplift. For selected countries whose sovereign ratings are unusually constrained by a high degree of political risk the uplift is restricted to two notches. This is intended to reflect the fact that a build-up in arrears to the IMF is often associated with political disruption. Zimbabwe, Somalia, Sudan and Liberia are currently in default on their IMF debt, so no rating uplift is applied to these four countries. For the portfolio overall the weighted average rating before uplift is 'B-'. Including uplift, the weighted average rating rises to 'BB'.

In reaching its rating judgements on the recipient country default risk Fitch has examined the historical experience of defaults on IMF debt dating back to the early 1980s. Over the period 1980 to 2002, some 25 countries fell into arrears to the IMF at some point. As at May 2006, four countries were in default to the IMF out of a total of 75 countries with IMF debts outstanding – a current default rate of 5.3%. The current IMF default rate is lower than that consistent with a 'BB' rating (around 13% over a 10-year horizon) but it did peak at 13% in the late 1980s (see chart below), when 11 countries were in arrears out of a total of 85 with IMF debts. With 25 occurrences of IMF arrears between 1980 and 2002 compared to 86 sovereign defaults to commercial and official creditors over the same period (according to World Bank data), the relative frequency of IMF defaults has been just one third that of all defaults. This difference in historical default experience is consistent with the four-notch uplift applied to the recipient country ratings (the probability of default for a 'B-' rating is around 35%, compared with 13% for a 'BB' rating).

Among the IFFIm pool of 70 recipient countries, 15 currently have no IMF debt at all. However, if they fell into financial difficulties there is a high probability that they would borrow from the IMF. Fitch therefore makes no distinction for these 15 countries in its analysis of IMF default risk over the horizon of the IFFIm programme.

#### Recovery Time Lag

Historically, the average (i.e. mean) time spent in default to the IMF has been seven years, although this is arguably distorted by four countries (Cambodia, Sudan, Liberia and Somalia) which were in arrears on their IMF debt for nearly 20 years. The median time in default is closer to four years. In its analysis Fitch assumes a recovery time lag of six



years. For the purposes of its CDO modelling of the recipient country default risk Fitch assumes that a country which defaults in its model simulation will see its rating restored to 'B-' immediately after the default is resolved. Fitch assumes no further migration to a higher rating, reflecting the agency's recent experience of post-default sovereign rating behaviour.

#### Default Correlation Among Recipient Countries

Correlations between the credit fundamentals of IFFIm recipient countries could arise from common economic shocks or from intra-regional spill-overs resulting from political upheavals – particularly emanating from the larger countries in a region. As many of the IFFIm recipients are low-income African countries, commodity price shocks would be an obvious common factor. An examination of the incidence of default on IMF debt shows that the incidence of protracted arrears increased in the mid-1980s, which did indeed coincide with a fall in global commodity prices. However, IMF defaults have also tended to be associated with country-specific political upheavals and the degeneration of a country into a failed or pariah state, leading to a breakdown in financial relations with developed world governments. In addition the majority of countries in the IFFIm portfolio have limited access to international capital markets, which reduces their exposure to global financial market contagion. These considerations suggest that credit correlations across the IFFIm portfolio may be relatively low. Fitch has assigned a portfolio correlation of around 15%, somewhat lower than the correlation assumptions normally used in CDO modelling.

#### Adjustment for Lower Rating of Italy

Italy, which accounts for 15% of the pledged donations, has a sovereign credit rating of 'AA' and is on Rating Watch Negative, reflecting the

<sup>5</sup> The Role of Multilaterals in Structured Finance, March 2006

deterioration in its growth and fiscal performance in the last couple of years. To ensure that the credit quality of IFFIm remains consistent with a 'AAA' rating, Fitch has made a reducing adjustment to Italy's contribution. Given the concentration of IFFIm's asset base among a few countries it has not been possible to use CDO modelling techniques to determine an appropriate size for the adjustment to offset the non-'AAA' status of Italy. Fitch has therefore applied a 'AAA' stress scenario in which it is assumed that four of the scheduled EUR26million annual payments from Italy are not forthcoming and that no recovery is subsequently made on these scheduled amounts. This assumption reduces the NPV of IFFIm's asset base, thereby decreasing the maximum gearing ratio (liabilities/NPV of total committed pledges). Fitch emphasises that this stress scenario should not, by any means, be viewed as the agency's expectation of the most likely course of

events – the 10-year probability of default for an entity rated 'AA' is 0.9%. Rather it is a means of ensuring that IFFIm's 'AAA' rating is robust to outlying events at the far extremes of the distribution of likely outcomes.

#### Monitoring

Fitch will monitor IFFIm's credit profile on a regular basis, taking into account its realised gearing ratio relative to the 73% limit. Developments in the underlying credit quality of the recipient countries, the observed pattern of IMF arrears and any perceived changes in donor sovereigns' ongoing commitment to IFFIm could warrant changes to IFFIm's rating or to the maximum allowable gearing ratio consistent with 'AAA'. The impact on IFFIm's credit profile of any potential new donors entering the programme in the future would also be considered.

Copyright © 2006 by Fitch, Inc., Fitch Ratings Ltd. and its subsidiaries. One State Street Plaza, NY, NY 10004.

Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. All of the information contained herein is based on information obtained from issuers, other obligors, underwriters, and other sources which Fitch believes to be reliable. Fitch does not audit or verify the truth or accuracy of any such information. As a result, the information in this report is provided "as is" without any representation or warranty of any kind. A Fitch rating is an opinion as to the creditworthiness of a security. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed, suspended, or withdrawn at anytime for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of Great Britain, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.