United Nations
Environment
Programme

Distr.
LIMITED

UNEP/OzL.Pro/ExCom/11/7
7 October 1993

ORIGINAL: ENGLISH

Executive Committee of
the Multilateral Fund for the
Implementation of the Montreal Protocol

Eleventh Meeting
Bangkok, 10-12 November 1993

DISCUSSION PAPER FROM THE TREASURER ON THE OPERATION OF PROMISSORY NOTES WITHIN THE CONTEXT OF THE MULTILATERAL FUND

The Use of Promissory Notes in the Payment of Contributions to the Multilateral Fund - A Discussion Paper

Second draft, 1 October 1993

Introduction

1. Article 10 of the Montreal Protocol (as amended) provides that "The Parties shall establish a mechanism for the purpose of providing financial and technical co-operation, including the transfer of technologies, to Parties operating under paragraph 1 of Article 5 of the Protocol to enable their compliance with the control measures set out in Articles 2A to 2E of the Protocol". Paragraph 2 of Article 10 provides that "The mechanism established under paragraph 1 shall include (the) Multilateral Fund" while paragraph 4 provides that "The Multilateral Fund shall operate under the authority of the Parties who shall decide on its overall policies". This latter paragraph is particularly relevant to this paper where a possible change in the relevant policies is discussed : if the Parties so decide the current policies (and procedures) could be amended.

2. At the tenth meeting of the Executive Committee of the Multilateral Fund, UNEP, as the Treasurer of the Multilateral Fund, was asked to prepare a discussion paper on how promissory notes would operate within the context of the Multilateral Fund, in consultation with the Sub-Committee on Financial Matters, the Multilateral Fund Secretariat and the implementing agencies.

3. As at the end of 1992, nearly $90 million had been paid into the Multilateral Fund in cash by way of agreed contributions of governments but another $35 million of contributions remained due and unpaid ($12.4 million of those unpaid contributions had been paid by end August 1993). Of the total of $90 million collected, $61 million had been committed (earmarked) by the Executive Committee before the end of 1992 for the work programme of projects (including the costs of the Multilateral Fund Secretariat) and cash for the full cost of this programme had been advanced by the Treasurer to the

implementing agencies. However, recorded expenditure in 1991 and 1992 in respect of that work programme was less than $13 million and at the end of 1992: $49 million was held by the implementing agencies, as undisbursed balances. Since the end of 1992, a further $44 million has been received by way of contributions and $48 million has been approved as additional projects by the Executive Committee and advanced to the implementing agencies. The level of total contributions received and the total of commitments approved by the Executive Committee at the time of each of its meetings is set out in the chart attached to this discussion paper.

4. The Fourth Meeting of the Parties to the Montreal Protocol (Copenhagen 23-25 November 1992) approved Terms of Reference for the Multilateral Fund. These terms of reference provide inter alia how contributions shall be determined, that no commitments shall be made in advance of the receipt of contributions and that income not spent in a budget year shall be carried forward from one year to the next. It also provides that any contributions not immediately required for the purposes of the Multilateral Fund shall be invested and that any interest, so earned, shall be credited to the Multilateral Fund. Any change in these arrangements, including arrangements for the payment of contributions, will require an amendment to the Terms of Reference of the Multilateral Trust Fund which would have to be approved by the Conference of the Parties. Clearly, paragraph 4 of Article 10 of the Protocol quoted in paragraph 1 above gives the Parties to the Protocol authority to change the arrangements as it deems appropriate.

5. Agreements entered into between the Executive Committee and the Implementing Agencies provide that a cash advance shall be made from the Multilateral Fund to cover the full cost of the work programme (projects) and amendments to the work programmes approved by the Executive Committee, whether or not disbursements by the agencies for their work programme will all be made in that year or over a number of subsequent years as in the case of some projects. As indicated above, the effect of this was that the implementing agencies held unutilized balances of $49 million in respect of the

Multilateral Fund as at the end of 1992. Any change in these arrangements will require amendment of the agreements between the Executive Committee and the implementing agencies. Such an amendment in these agreements would be a sine qua non to any change in the form of contributions to the Multilateral Fund.

6. Experience in the operations of the Multilateral Fund has made it apparent that there is a delay between the receipt of contributions and the approval of new projects by the Executive Committee who generally meet three times each year. Such delays are unavoidable when contributions are paid late in the year, although they would not arise if all contributions were paid at the beginning of the year to which they relate. It is also clear that there is delay between the approval of new projects by the Executive Committee and the implementation of projects on the ground by the implementing agencies : projects have to be formulated in detail together with the authorities of the country where they are to be implemented. These delays or gaps - both in large measure unavoidable - mean that cash balances not immediately required for disbursement on approved projects will be an observed phenomena at all times under the rules within which the Multilateral Fund currently operate, either with the Multilateral Fund itself or with the agencies. This would not matter if the contributing governments were prepared to accept such delays as inevitable but it has become apparent that some are reluctant to do so and are in some cases withholding their contributions to the Multilateral Fund for the reason that the cash balances are perceived as being unreasonably high. The level of the programme approved is lower than it would otherwise be in consequence.

7. It was reasonable when the Multilateral Fund was first established as a new source of international financing that the Parties to the Montreal Protocol should be cautious in the instructions they gave to the Executive Committee concerning the approval of commitments. Similarly, it was to be expected that the implementing agencies would be cautious in accepting responsibility for new programmes without the assurance of full funding being provided in advance. Although the rate of expenditure on projects is bound to increase in 1993 and in subsequent years, it can still be anticipated, particularly

for investment projects, that expenditure may spread over several years after a project has been given a go-ahead by the Executive Committee. Cash balances held by the agencies in the form of undisbursed advances for projects approved by the Executive Committee will thus remain high if the current practice is maintained of advancing to the implementing agency the full cost of a project immediately it receives approval by the Executive Committee. Concern on the part of contributing governments regarding the level of these balances, seems however, bound to continue, since governments will be contributing funds from hard pressed budgets and are not being used immediately for the programmes for which they were paid. An agreed system of contributing to the Multilateral Fund in the form of promissory notes is a way of meeting these concerns. At the same time, the Executive Committee (and the agencies) must have total assurance that financial resources will be available when required for all projects given a go-ahead.

8. The facts outlined above suggest that it is now appropriate that additional systems of contributing to the Multilateral Fund should be explored in the light of experience since the Multilateral Fund was first established. The principal alternative suggested is the promissory note and for that reason the Executive Committee has called for a discussion paper on how promissory notes would operate within the context of the Multilateral Fund, taking fully into consideration, inter alia:

- how encashment (draw down) schedules of promissory notes would be implemented to avoid cash flow problems;
- how promissory notes worked in other international financial institutions and international organizations;
- the impact of promissory notes on the amount of interest earnings;
- the implications of the wide-scale use of promissory notes by Parties not operating under Article 5, paragraph 1;
- the implications on the approval of projects by the Executive Committee in advance of encashment of promissory notes, given the provisions of the Montreal Protocol, the decisions of the Parties and agreements with implementing agencies;

- whether the use of promissory notes was in accordance with the existing financial procedures of the Fund;
- whether the Executive Committee was required to seek a mandate from the Meeting of the Parties on the use of promissory notes; and,
- the fact that the Multilateral Fund was a relatively new mechanism.

The Promissory Note

9. Promissory notes can be established in various forms but, in relation to the Multilateral Fund, they have been seen as a non-negotiable, non-transferable, financial instrument that provides for the payment of contributions in respect of a given year, not all in cash on the first day of the year (which is, at least in theory, the practice now) but through a series of encashments over a number of years, broadly related to the projected cash needs of the Multilateral Fund (including its implementing agencies). A variation of such a note is an irrevocable undertaking to pay on demand, without regard to any encashment dates set out on the promissory note, if it is found that cash disbursements are required at a faster rate than is assumed in any schedule of encashments set out in the note. Such a variation obviates totally any risk of the Multilateral Fund finding itself without cash as a result of cash needs being higher than projected and reflected in the encashment profile of the notes.

10. A further variation is where the government authorities authorize the monetary authority to disburse monies to the Multilateral Fund against the promissory note in the same proportion the governments contribution percentage relating to the Fund bears to the total approved commitments of the Multilateral Fund. This is, however, something of a "Catch 22" situation if the Executive Committee cannot approve commitments until the cash is received and the contributing governments will not pay cash until the commitments are approved.

11. Promissory notes would normally be non-interest bearing and non-negotiable (i.e. they cannot be transferred to a third party). They would normally be held until encashment by the contributing government's central monetary agency (with a copy being held by the Treasurer of the Multilateral Fund). The central monetary agency would have an irrevocable obligation to pay cash to the Multilateral Fund in accordance with the encashment profile set out in the note. This is not the same as a pledge to pay a contribution as is given by governments at meetings of the Parties to the Protocol : it would be an irrevocable undertaking which if not met would cause the government concerned to be in default on its international debt.

12. Once promissory notes are deposited with the central monetary authority, they may be regarded and recorded as payments of contributions to the Multilateral Fund against which project commitments can be approved by the Executive Committee once the Parties to the Protocol so decide that they shall be so regarded by amendment of the Terms of Reference of the Multilateral Fund. So long as the encashment profiles of the notes broadly represent the actual disbursement requirements of the Multilateral Fund (and its implementing agencies), no risk would be incurred in entering into such commitments: cash would always be available when required. The advantage to the contributor would be that although the establishment of the promissory note involves the same outflow from the national treasury as the payment of cash in full on the same date, the actual cash outflow from the national economy is staggered in accordance with the schedule of payments provided in the note. On a discounted actuarial basis, the outflow of currency is lower than it would have been with a single cash payment.

13. The disadvantage to the Multilateral Fund would be that it would not have all the cash in its bank account on the date the promissory notes are deposited and in these circumstances the Multilateral Fund must be confident that it can project its disbursements for approved commitments with some certainty and match those projected disbursements against the proposed encashment profiles of the promissory notes. This will be difficult because the type of projects financed by the Multilateral Fund varies and

may not be same in the years ahead as they have been in the past. On the other hand, the risks involved in such projections of cash requirements could be effectively eliminated by provision in the notes that notwithstanding the encashment profile set out in the notes, cash could be called up on demand in the event of an unanticipated cash requirement in the Multilateral Fund.

14. Since under the promissory note system, the Multilateral Fund cash balances would not be as high as previously, the Multilateral Fund would lose the advantage of accruing interest: a total $2.3 million was earned by way of interest in 1991 and 1992, including interest earned by the implementing agencies on balances held by them. Since the purpose of the Fund, however, is to implement programmes rather than earn interest on unutilized cash balances, this should not perhaps be seen as an important issue for the Multilateral Fund and might be seen as an advantage by the contributors who will in effect accrue the interest themselves.

15. For the contributors, the system of promissory notes spreading out resource outflows over time would have advantages, since on a discounted basis, the outflow of cash could be regarded as lower. On the other hand, these advantages might be seen as falling only to the larger contributors who wish to use such a system of promissory notes Some may see the system as involving them in unwelcome administrative tasks, while others may see it as failing to overcome the basic budgetary balance of payments problem of paying contributions at all. Thus, the introduction of promissory notes as an acceptable basis of contributions to the Multilateral Fund will not overcome, in particular, the problems of countries in transition in finding the resources necessary to meet their contributions obligations.

16. For the implementing agencies, the payment of contributions through promissory notes with staggered encashment would mean that their implementation agreements with the Executive Committee would as a sine qua non have to be amended to provide that cash would not be advanced at the time a project was given a go-ahead by the Executive

Committee and that either cash would be advanced on an "as and when needed" basis or provided on the basis of a fixed schedule of cash advances related to the life of the projected disbursement requirements for their portfolio of projects as a whole. Whichever alternative is adopted, it might be advisable to provide that the agencies should not hold cash above the level of say six months requirements overall.

17. The overriding problem that has to be overcome, however, is the interpretation of the current wording of paragraph 20 of the terms of reference for the Multilateral Fund agreed by the Fourth Meeting of the Parties to the Protocol in Copenhagen which reads "No commitments shall be made in advance of the receipt of contributions". If the definition of "contributions" can be understood or be defined explicitly to state "including the deposit with independent monetary authorities of irrevocable promissory notes on terms acceptable to the Executive Committee", the Executive Committee could approve commitments against the full amount of the notes received as payment of contributions. The wording of any promissory notes accepted must ensure that the Multilateral Fund always has sufficient cash resources available to meet disbursement needs. At the moment, this interpretation is not placed upon the meaning of the word "contributions" and since some governments are withholding cash contributions because they are not permitted to contribute by way of promissory notes the size of the programme of work approved by the Executive Committee is constrained accordingly.

18. A disbursement schedule for the Multilateral Fund based on actual cash needs would be very difficult to project, given the very limited experience of project implementation on the ground since the Multilateral Fund was established. With the assistance of the implementing agencies, it should be possible to attempt this for the existing portfolio of projects but the future portfolio and thus the cash disbursement profiles may be very different from that of the past. Implementing agencies will also tend to play safe and thus assume a too optimistic attitude to the rate of their project implementation and their near term cash requirements. In these circumstances, a promissory note that provides for fixed installments of cash against the note on fixed

dates over say five years with the first instalment payable in the year the contribution is due, reinforced with the right of the Multilateral Fund to encash all or part of the note on demand in the event that there is a cash shortfall at any time without regard to the instalment payments set on the note would seem to be a reasonable compromise.

19. All contributors should have equal right to contribute in the form of promissory notes, while not being obliged to do so if they prefer to contribute in cash in the year of contribution as in the past. Similarly, if there is a need for an emergency call of cash against promissory notes, all governments who had made contributions in the form of notes would be required to meet the cash call in equal proportions. The wording of promissory notes and the payment dates for each cash instalment would be identical for all promissory notes accepted against a particular year of contribution without regard to the dates on which the promissory notes may be deposited. All promissory notes, all Multilateral Fund commitments and all cash advances to implementing agencies should be designated in U.S. dollars in order to minimize currency risks for the Fund.

20. All unpaid contributions relating to earlier years would be regarded as outstanding and payable in cash or in kind, in accordance with existing arrangements. They should not qualify for payment under the new arrangements in the form of promissory notes since the facility has not been available to those that have already paid their contributions in full. Subject to the agreement of the Parties to the Protocol at their next meeting, it is suggested that the new arrangements should come into effect for 1994 contributions and for subsequent years.

21. Initially (i.e. for 1994), it is suggested that the encashment profile to be set out in the common promissory notes would be ten half yearly payments of equal amounts with the first payment due on the first day of the year (i.e. 1 January 1994) and the second on 1 July 1994 within eight half yearly payments on 1 January and 1 July thereafter. In the event that the timing of a governments financial year precludes the first encashment on 1 January that encashment tranche would be rolled up with the first

encashment possible. In the event that there is still an accumulation of cash in the Multilateral Fund, taking into account the rundown of cash balances held by the implementing agencies, the Executive Committee should be authorized to review the encashment schedule and if it decides that it is feasible to do so, lengthen the encashment period in subsequent years beyond the five year period provided by 10 equal half yearly encashments proposed for 1994 notes. If on the other hand, experience indicates that cash is required at a faster rate, the Executive Committee should be authorized to shorten the encashment period.

22. The Executive Committee would be authorized by the Parties to commit funds up to the full value of the notes deposited with a copy to the Treasurer as soon as they are deposited with a recognized depository. Thus, there would be no negative impact (and indeed in all probability a positive impact) on the Executive Committee's approval of projects. The terms of reference of the Multilateral Fund would be amended to reflect this at the next meeting of the Parties to the Protocol. Implementing agencies would be advanced cash by the Treasurer on request only against approved commitments and evidence of cash need to meet upcoming disbursements. The agreements between the Executive Committee and the Implementing Agencies would be amended to reflect the introduction of this new arrangement.

23. The Treasurer of the Multilateral Fund would report regularly at each meeting of the Executive Committee the amounts contributed to the Multilateral Fund in cash and the amounts contributed in the form of promissory notes (taking into account the regular encashment of notes) and the cash available in the Multilateral Fund to meet disbursement requirements.

24. One slight complication relates to the need to integrate any new system of paying contributions to the Multilateral Fund with the existing provisions that permit bilateral or regional assistance programmes approved by the Executive Committee to be counted as contributions to the Multilateral Fund up to a limit of 20 per cent of any governments

total contribution due. There is no need for this provision to be changed if governments are to be permitted to contribute with promissory notes but those governments that do so should try to nominate bilateral or regional assistance programmes for approval by the Executive Committee in advance of the year against which they are to be counted as contributions to the Multilateral Fund, so that the residual part of the contribution can be included in a promissory note or, alternatively, the value of such assistance approved later could be counted as a credit against the following year's contribution.

Experience of Promissory Notes in Other Financial Institutions

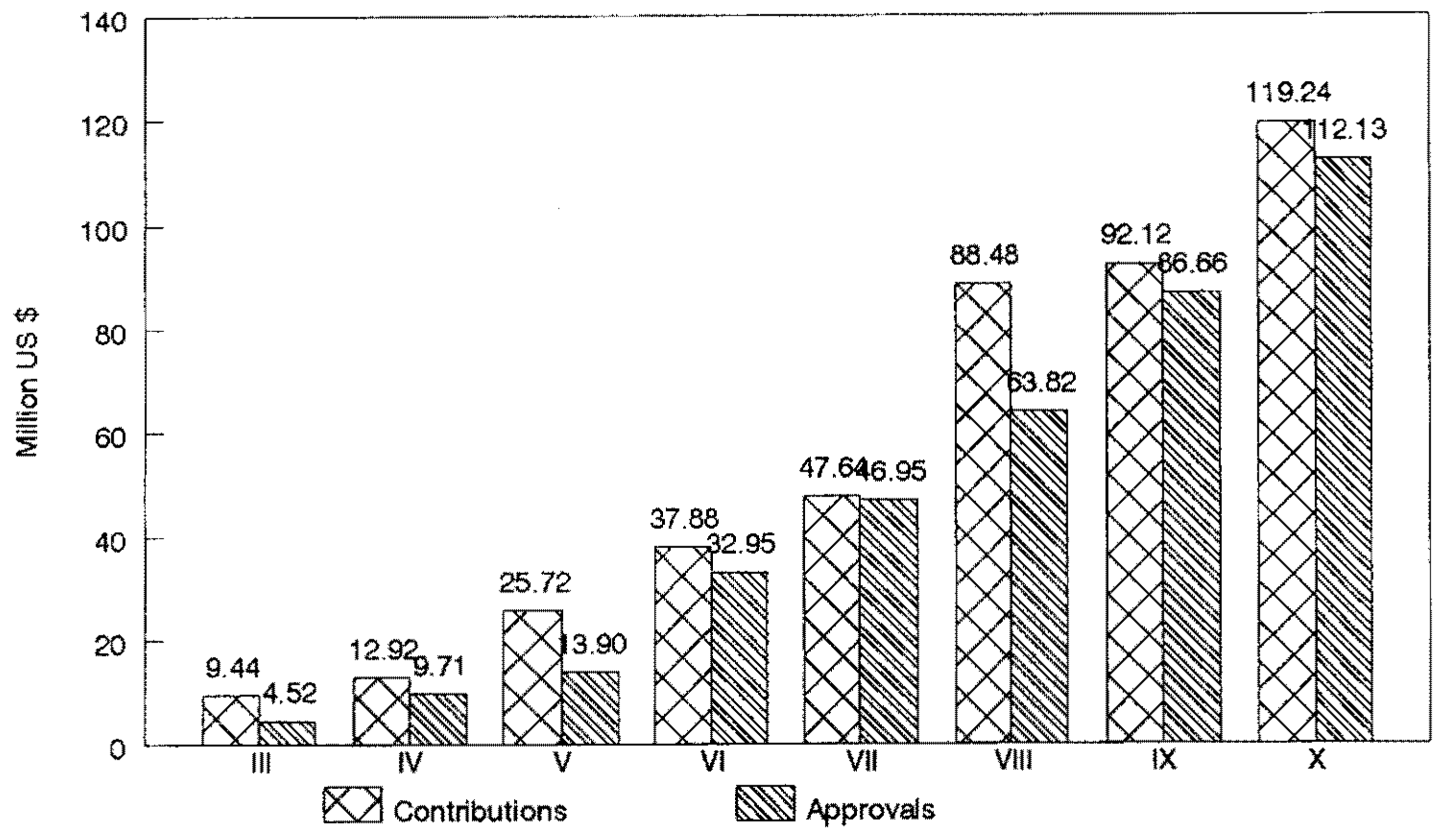
25. Promissory notes are used in the payment of contributions in other international financial institutions, notably the World Bank and its affiliated organizations, and the GEF. Encashment against the notes is generally on the basis of projected disbursement needs but there is increasing recognition of the difficulties of making such disbursement projections, particularly for new financial mechanisms such as the GEF, and also a recognition of the advantages to donors of pre-established predictable encashment profiles which can be programmed into budgetary allocations. It seems likely that for contributions to the GEF at least, donors will move in this direction. One approach which is being recommended for GEF is to a have a needs based encashment schedule with reasonably stable levels of expected encashments, backed up by a cash reserve to cover unforseen transitory outlays.

26. Another important and difficult issues within such a promissory note based system is the possibility that the Multilateral Fund, having received promissory notes from donors, proceeds to deliver its own promissory note to implementing agencies. Such an approach is unlikely to be considered acceptable by the agencies, however. Clearly, the reason it works alright in the case of the GEF is that the World Bank receives promissory notes from donors and subsequently can provide its own promissory notes to e.g. UNEP, which accepts this because of the World Bank's high credit rating.

27. Another approach, more likely to be acceptable, is that the promissory notes from donors to the Multilateral Fund are in fact made "negotiable" in a limited sense -- that is, they can be transferred, through endorsement, only to any one of the executing agencies. Thus, the Multilateral Fund could directly endorse such notes over to the respective executing agencies, who then would be able to encash the funds directly according to the agreed upon terms. However, some issues of fair distribution of credit rating surfaces regarding the perceived value ratings of promissory notes.

28. The United Nations itself has no experience of contributions being made other than in cash, since up to now contributions, whether on an assessed or voluntary basis, are required to finance specific approved budgets for the year or biennium ahead. There was no experience in the United Nations of investment programmes such as that financed by the Multilateral Fund before the Fund was established, but UNDP and UNEP are now implementing this programme as well as the Global Environment Facility where cash is issued to them for approved projects on the basis of estimated cash needs. United Nations organizations cannot, under their Financial Rules, enter into formal financial obligations without cash being readily available to meet those obligations. Experience exists in both organizations, however, of projecting cash requirements to meet such obligations on a total project portfolio basis. Cash advances are made to their own executing agencies on the basis of quarterly or half yearly cash requirements for the total project portfolio sufficient to meet such financial obligations. Such advances would be something less than the total project portfolio value.

CONTRIBUTIONS AND APPROVALS BY EXECUTIVE COMMITTEE MEETINGS



	III Apr 1991	IV Jun 1991	V Nov 1991	VI Feb 1992	VII Jun 1992	VIII Oct 1992	IX Mar 93	X Jun 93
INCOME	9,438,155	12,924,761	25,717,491	37,879,082	47,636,976	88,483,659	92,122,077	119,241,438
DISBURSEMENTS	4,519,553	9,708,273	17,899,376	32,954,771	46,945,771	63,821,331	86,661,529	112,125,158
SURPLUS	4,918,602	3,216,488	7,818,115	4,924,311	691,205	24,662,328	5,460,548	7,116,280

c:\assess\balance1.wk3 & balance2.cgm