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Report of the Secretary-General

Addendum

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Annex

Explanatory note on outside commercial borrowing*

A. Possibilities for outside commercial borrowing

1. The viability of outside commercial borrowing was examined with the assistance of a financial consultant. Several possibilities were considered, including loans guaranteed by Member States, borrowing against the assets of the Organization and a bond offering. The first possibility was not considered practical since it would require individual Member States to act as legal guarantors of a loan granted to the Organization. The second possibility, outside borrowing against the Organization's assets, was not considered viable due to the United Nations special status under the Convention on the Privileges and Immunities of the United Nations. The third possibility, a bond offering, is considered viable for the reasons explained below.

B. Bond offering

2. A bond offering represents a written obligation of the issuer to repay a loan under specific terms, including the term of years for repayment and the interest rate to be charged on the loan.

C. Financial mechanisms associated with a bond offering

3. In order for the Organization to be in a position to make a bond offering to capital markets, Member States would have to agree to the establishment of certain financial mechanisms geared to assuring investors (i.e., the bond holders) of the return of their investment. The principal mechanism to be established would entail Member States tendering their assessment payments directly to a bond trustee, normally a major financial institution, which would be authorized by the United Nations to "set aside" a certain percentage of the assessment payments for the sole purpose of meeting the required annual debt service payment (i.e., principal and interest) under the bond offering. Once the required annual debt service payment amount was reached, the trustee would no longer set aside any portion of the assessment payments, which would then be fully directed to the United Nations regular budget. At all times, Member States would be credited the full amount tendered to the bond trustee, regardless of the assessment set aside for debt servicing purposes.

D. Debt service coverage and bond interest

4. Lower interest rates on loans are available in capital markets to borrowers who have ample "debt service coverage", which is defined as total revenues available for debt service as a percentage of the *required* debt service. The availability of ample

* Previously issued in document A/55/117.

debt service coverage reduces the financial risk to investors and translates into lower borrowing costs for the borrower.

5. Ample debt service coverage for a United Nations bond could be created by permitting the trustee to set aside a higher-than-required percentage of assessment payments tendered by Member States to permit the accelerated collection by the bond trustee of the total annual debt service requirement. Such an arrangement would provide a "cushion" to protect investors from potential or unanticipated declines in the expected flow of revenue available for debt servicing. Once the total annual debt service requirement was reached, all assessment payments received by the trustee would be fully directed to the United Nations regular budget. In order to achieve the ample debt service coverage and taking into account the historical pattern of assessment payments by Member States, investors would probably require 250 per cent of the normally required debt service percentage to be set aside from assessment payments early in the calendar year, thereby allowing the total annual debt service requirement to be reached more quickly every year.

6. As an illustration, if the annual regular budget were $1,198 million and were increased by $52 million to accommodate capital master plan debt service, a Member State with a regular budget assessment of 10 per cent would contribute $125 million towards the regular budget ($1,198 million plus $52 million = $1,250 million; 10 per cent of $1,250 million = $125 million). The portion of the assessment due for plan debt service, or "assessed plan debt service", would be 10 per cent of $52 million, or $5.2 million. Assuming the contribution was made early in the calendar year, a Member State with a 10 per cent regular budget assessment would have 250 per cent of the assessed plan debt service amount retained for plan debt service by the trustee, which in this example would amount to $13 million (250 per cent of $5.2 million = $13 million). By the trustee retaining a higher proportion of early regular budget contributions, the bond holders would be assured that the annual debt service requirement would be met in a timely manner. In this illustration, upon tendering full payment of its assessed contribution, the Member State would receive full credit for its contribution to the regular budget ($125 million), $13 million would be retained by the trustee and applied towards the annual plan debt service payment, and $112 million would be released to the regular budget.

7. The end result of providing ample debt service coverage in the manner described above would be a high-to-medium grade "credit rating" for the United Nations loan, which would in turn reduce the overall cost of borrowing. A description of how credit ratings for a United Nations bond would be established is set out below.

E. Credit rating of United Nations bond

8. Any United Nations bond issue would be evaluated by market participants and potential investors by its credit rating, which is a formal evaluation of the creditworthiness of the bond issue by an independent credit rating agency. An "investment grade" rating reflects the credit rating agencies' belief that the probability of payment of the bond is high and the financial risk associated with the investment is low.

9. Investors use credit ratings as a factor in pricing loans on bonds. The more secure the borrowing, the more likely the investor is to get its loan repaid and the less risk is involved in making the loan. When investors make less risky loans, they require a lower “risk premium”, thereby reducing the cost of borrowing to the borrower.

10. In establishing a credit rating on a United Nations bond issue, the credit rating agencies would focus on the source and probability of timely debt service payments, in accordance with the terms applicable to the bond issue. The United Nations goal with respect to the credit rating would be to convince the credit rating agencies to treat the borrowing as “quasi-sovereign” for credit rating purposes. Sovereign obligations, such as bonds, are commonplace in the capital markets, and demonstrate strong investor demand and confidence. The obligations of certain organizations, such as the World Bank, are defined as quasi-sovereign by the credit ratings agencies. Like the World Bank, United Nations budget assessment payments are obligations of Member States, and accordingly United Nations obligations (i.e., the bond issue) would probably be eligible to be defined as quasi-sovereign. That would provide the United Nations with the benefit of a higher credit rating, which would result in a lower cost for borrowing.

11. The credit rating agencies would probably evaluate the United Nations for credit rating purposes based on various criteria, including:

(a) Credit and security structure;

(b) Breadth, stability, predictability and collectability of revenue;

(c) Revenue source’s protection from adjustment;

(d) Structural elements (e.g., trustee, funds flow, timing);

(e) Debt service coverage;

(f) Rationale for the borrowing and the project’s importance.

A financial consultant firm has advised that the United Nations could expect to receive a credit rating in a range between the “AA” (very high grade, high quality) and “A” (upper medium grade) categories.

12. Member States might wish to note that a United Nations bond issue’s potential appeal to investors could be enhanced by limiting the number of Member States whose assessment payments would be subject to the “set aside” mechanism described in paragraph 3 above, which would not only reduce the number of Member States whose assessment payments were used to meet the total annual debt service requirement but would also reduce the number of Member States required to be analysed by the credit rating agencies to establish the credit rating of a United Nations bond. Implementation of that approach would essentially result in the utilization of the high credit ratings of some Member States to enhance the overall credit rating of a United Nations bond issue, which would benefit all Member States since it would lower the overall cost of borrowing. Moreover, including a smaller number of Member States in the set aside mechanism would facilitate consideration of any United Nations bond offering by market participants and would probably prove easier and less costly for the bond trustee to administer. It should be emphasized that irrespective of whether a particular Member State’s assessments

were utilized for set aside purposes, all assessments received by the bond trustee would be fully credited to assessed contributions.

F. Level annual debt service

13. The bonds can be structured to mature (i.e., come due) over 25 years, resulting in level annual debt service requirements. Upon the issuance of the bonds, the United Nations would invest the bond proceeds in a project construction fund account to be invested over the period of construction. Construction fund earnings would be applied to the annual debt service requirement, thereby reducing the net annual debt service to be met by the set aside procedure.

G. Agreements required

14. Two agreements would be required to be entered into for the purposes of issuing a United Nations bond:

(a) *Agreement between United Nations and participating Member States*. Every Member State involved in the set aside mechanism would be requested to enter into an agreement with the United Nations, acknowledging that its assessments would be subject to the set aside mechanism and that any assessment payments received by the bond trustee would be fully credited against its regular budget assessment;

(b) *Agreement between participating Member States and the bond trustee*. Every Member State whose assessments would be subject to the set aside mechanism would enter into agreement with the bond trustee, acknowledging that fact and that any portion of the assessment payments received by the bond trustee not used for set aside purposes would be directed to the United Nations regular budget.