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EXECUTIVE COMMITTEE OF
THE MULTILATERAL FUND FOR THE
IMPLEMENTATION OF THE MONTREAL PROTOCOL
Fifty-first Meeting
Montreal, 19-23 March 2007

**REVIEW OF PROMISSORY NOTES POLICY
(FOLLOW UP TO DECISION 50/44 (C))**

INTRODUCTION

1. The issue of the encashment of promissory notes was raised by the Treasurer in the context of the Status of the Contributions and Disbursements document and also in the context of the Reconciliation of the accounts agenda item as shown in paragraph 180 of the Report of the 50th Executive Committee meeting, when the Treasurer drew the Committee's attention to the reluctance of implementing agencies to accept promissory notes which are not cashable upon demand.
2. Therefore, through decision 50/44 (c) the Executive Committee requested the Treasurer to review the Executive Committee's policy on promissory notes in recognition of changing financial requirements. The need for this review arose due to the significant impact of the notes in the overall financing of the Fund and also the impact of the cash flow resulting from the encashment of the promissory notes on the timely execution of programmes approved by the Executive Committee.

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BACKGROUND

3. Early in the operation of the Multilateral Fund, delays occurred between the approval of new projects by the Executive Committee and the implementation of projects by the Implementing Agencies (IAs). This was attributed to projects having to be formulated in detail together with the authorities of the countries where the projects were to be implemented. These delays created cash balances in both the Fund and the IA's accounts. Parties expressed concern about this situation and some withheld their contributions. The need therefore arose to find a mechanism that would address the issue of the excess cash balances.
4. At its Tenth Meeting, the Executive Committee requested the Treasurer to submit a discussion paper on the use of promissory notes to its Eleventh Meeting. On the basis of this paper, the Eleventh Meeting of the Executive Committee decided that, in future, promissory notes could constitute committable resources and that the deposit of a promissory note would be considered to be payment towards a country's contribution to the Fund.
5. Since then promissory notes, in relation to the Multilateral Fund, have been defined as a non-negotiable, non-interest-bearing and irrevocable financial instrument that provides for the payment of contributions to the Fund, in respect of a given year, to be either payable on demand or through a schedule of encashment as set out in the note.
6. Thus far, the Parties to the Fund that have opted for the use of promissory notes in the payment of their contributions are Canada, France, Germany, Netherlands, United Kingdom and United States of America. It should be noted that some of these Parties have made their contributions entirely through promissory notes whilst others have used a combination of promissory notes and cash.

BRIEF HISTORY OF THE USE OF PROMISSORY NOTES

7. In 1992, France became the first Party to notify the Treasurer of the deposit of promissory notes towards the settlement of its 1991 and 1992 contributions. Germany became the next Party, in 1994, to issue promissory notes for the same year's contribution. In 1995, Canada, the Netherlands and the United Kingdom also issued promissory notes for their contributions to the Fund. The United States of America issued its first promissory note in 1998.
8. Prior to the introduction of the Fixed-Exchange-Rate Mechanism (FERM) in 2000, any loss or gain due to exchange rate fluctuation for the notes issued in non-United States dollars, was debited or credited to the contributing Government. However, under the FERM, the exchange rate risk for promissory notes denominated in non-United States dollars was borne by the Fund.

ENCASHMENT OF PROMISSORY NOTES

9. At the Eleventh Meeting of the Executive Committee, it was decided that promissory notes could be cashed using a schedule with the caveat that the Treasurer could, on demand, accelerate encashment, in light of needs and on a pro rata basis. The Treasurer was requested to submit a draft schedule for the drawing down of the promissory notes at the Twelfth Executive Committee Meeting.
10. At its Twelfth Meeting, the Executive Committee presented an initial encashment schedule, which could later be modified based upon experience gained. A review of the encashment schedule shows that each promissory note was to be drawn down over a period of three years, commencing the year following the year the promissory note contribution related to. In effect, one-sixth of the value of each note was to be drawn twice a year.
11. Only two of the six Parties using promissory notes, opted for using the encashment schedule. Some of the Parties chose to expedite the encashment of their notes in less than the six instalments over three years. Other Parties chose to encash their promissory notes in one payment only, or to make their contributions in a combination of both cash and promissory notes. With these arrangements in place, it became increasingly difficult to determine the cash flow available for project commitments.

CURRENT USE OF PROMISSORY NOTES

12. The main reason for opting to use promissory notes was to reduce the excess cash balances held by the Fund and IAs when programme implementation had not started. However, the situation has now changed and reached a stage where IAs have been called upon to wait (in some instances for many months) before funds approved for projects could be released to them. This is primarily the result of resources available in promissory notes, which can only be cashed over a period of three years unless the Parties respond positively to the Treasurer's request for accelerated encashment.
13. As an example of the problem of having funds confined within promissory notes, the amount of US \$45,116,594 due to an agency after the 47th Executive Committee Meeting, which ended on 25 November 2005, could only be paid on 29 September 2006. The funds only became available through the combined efforts of the Treasurer, the Governments of France and the United Kingdom when these Parties agreed to accelerate the encashment of their promissory notes.
14. The 50th EXCOM provides a more recent example. The total balance available for new allocations at the end of the 50th Executive Committee meeting was US \$57.6 million. Included in this amount were promissory notes worth US \$27.9 million. Since the end of the meeting, an additional cash contribution of US \$6.8 million has been received. Based on the levels of programme approvals at the meeting and taking

- into consideration adjustments arising from the interest earned by IAs in 2006 and the reconciliation of the 2005 accounts, the Treasurer needed to disburse the sum of US \$38.7 million to the IAs. The Fund's bank balance, which then stood at approximately US \$36.5 million, was not sufficient to meet this requirement. Moreover, a sufficient cash balance needed to be retained to accommodate the Secretariat's operations and any unforeseen expenditures. It was therefore agreed to pay all the IAs in full, with the exception that UNEP agreed to be paid part of the amount due pending the availability of cash.
15. Subsequent to the payments referred to above, the Secretariat instructed the Treasurer to release the sums of US \$1,265,642 and US \$1,088,800 to the World Bank and UNDP respectively based on approvals made at the 48th Executive Committee meeting and the follow up to decision 50/33 of the 50th Executive Committee meeting. This left an unpaid balance to the IAs of US\$ 5.4 million pending the receipt of cash contributions to the Fund.
 16. Despite the Executive Committee's decision that the Treasurer has the option of requesting for the early encashment of promissory notes, in light of the needs of the Fund, it has emerged that not all the Parties using promissory notes have the flexibility in their internal arrangement to meet the Treasurer's request. (See paragraph 28 for further explanation of the nature of this inflexibility.) To compound this problem only one of the IAs was in a position to accept promissory notes and has, as a result of encashment difficulties, indicated that they are no longer willing to entertain their use.
 17. Currently, when the Treasurer determines that there is the need for accelerated encashment based on the cash requirements of the Fund, letters are sent to the Government officials with whom we liaise on the notes. They are informed of the cash needs of the Fund and the need for the encashment of their note(s). The Treasurer's letter makes references to the decisions of the Parties that authorized the Treasurer to request for accelerated encashment of the notes. If considered appropriate, we would include officials of the Central Banks of the Parties in our communication.
 18. As evidence, the Treasurer assigned promissory notes worth US \$14,437,896 to one of the IAs for the projects approved for it at the 45th Executive Committee Meeting. The assigned promissory note formed part of the 2004 promissory notes held by one of the Parties. In July 2005, the agency requested the Treasurer to facilitate the encashment of the note based on its needs. However when the Treasurer made the request, he was informed by the Party of its inability to accelerate the encashment of the note due to budgetary regulations. The Treasurer had to cancel the assignment of the promissory note and to find an alternative source of paying the agency.
 19. As at the end of the 50th Executive Committee Meeting, the Fund had promissory notes worth US \$27,902,082 in its stock. According to the encashment schedule, the payments are to be made as follows: 57% in 2007, 26% in 2008 and 17% in 2009

after the replenishment to which the contribution was pledged. The Executive Committee however, approved the programme implementation for these contributions. The IAs, based on the terms of the agreement reached with them, are only obligated to start activities supported by the Fund if and when the resources approved have been transferred to them.

20. Our understanding of the agreements signed with the implementing agencies is that they are to consider promissory notes assigned to them to be resources available for the “making of commitments” only. The agencies would not be expected to implement projects without having been paid the full sum for all agreed activities once approved. They cannot therefore be expected to utilize the funds on hand for newly approved projects unless the Executive Committee would like to engage them in discussions towards amending the agreements.

THE WAY FORWARD

21. In line with the decision taken by the Executive Committee at its Twelfth Meeting, which stated that the encashment schedule could be modified on the basis of experience gained, this may be an appropriate time to review the encashment and use of promissory notes.
22. There is no assurance that all Parties would accelerate the encashment of their promissory notes when requested to do so by the Treasurer. At the same time IAs are not prepared presently to accept notes in lieu of cash payment. Therefore as programme approval is based on the total resources available, including promissory notes received, there is the continuing danger of liquidity in relation to approved programmes.
23. In continuing with the use of promissory notes, it is suggested that the amount of promissory notes not due for encashment upon demand should be taken into consideration in the determination of resources available to the Committee for project approvals, and not considered as resources available for immediate commitment when approving projects. This would provide clarity on the actual availability of funds for immediate use.
24. The Executive Committee may wish to consider requesting the six Parties using promissory notes to renew their commitment, to the Executive Committee’s decision which, allowed for the accelerated encashment of promissory notes based on the demand of the Treasurer.
25. Whilst promissory notes continue to be used it is recommended that the Status of Contributions and Disbursements report clearly indicates the availability of cash and the encashment schedule of promissory notes and that the availability of liquid resources is fully acknowledged in the programme of work.

RECOMMENDATIONS

26. The Executive Committee may wish to:
- (a) Note the report of the Treasurer on the review of the Executive Committee's policy on promissory notes as requested through decision 50/44 (c);
 - (b) Recall paragraph 180 of the Report of the 50th Executive Committee meeting in which the Treasurer drew the Committee's attention to the reluctance of implementing agencies to accept promissory notes which are not cashable on demand, keeping in mind existing agreements between the Executive Committee and the Implementing Agencies on the acceptance of Promissory notes.
 - (c) Encourage Parties to make their contributions in the form of cash in order not to delay project implementation on the part of implementing agencies;
 - (d) Request Parties continuing to use promissory notes to be flexible in meeting the Treasurer's request for accelerated encashment of their notes in order to mitigate cash flow problems.