

***Publication No. 4***

# **OVERVIEW OF DEBT CONVERSION**

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## Foreword

This publication series has been launched in response to the increasing number of requests *Debt Relief International (DRI)* has received for information on the activities of the *Heavily Indebted Poor Countries (HIPC) Initiative Capacity Building Programme (CBP)* and on the technical aspects of debt analysis and negotiations needed to develop and implement national debt strategies. The aim of the HIPC CBP, funded by five European governments (Austria, Denmark, Sweden, Switzerland and the United Kingdom), is to build and strengthen the capacity of HIPC governments to develop and implement their own national debt relief strategy, and a new borrowing policy consistent with long-term debt sustainability, without having to rely on international assistance. DRI is its non-profit implementing organisation.

This series arises from DRI's experiences of working with 32 HIPC countries and in particular conducting national, regional and international workshops on debt strategy, debt negotiations, macroeconomic forecasting and poverty reduction. It is targeted mainly at senior officials and policy makers in HIPC countries, but it will be useful for officials of regional African, Asian and Latin American organisations, NGOs and academics in developing and developed countries.

The aim of the series is to present particular topics in a concise, accessible and practical way for use and implementation by HIPC governments. The series should enable senior officials and policy makers to focus on some of the key issues relating to long-term debt sustainability, macroeconomic forecasting and poverty reduction in HIPC countries. Each publication is intended to be reasonably self-contained.

The views expressed in the publications are those of the authors and not necessarily those of the HIPC CBP donors.

We welcome any comments on this publication or suggestions for other topics to be included.

Alison Johnson  
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**ACRONYMS AND ABBREVIATIONS**

<b>ACDE</b>	<i>Association Conseil pour le Développement et l'Environnement</i> (France)
<b>BMZ</b>	Ministry for Economic Co-operation and Development (Germany)
<b>CFA</b>	<i>Communauté financière africaine</i> (franc zone)
<b>CIDA</b>	Canadian International Development Agency
<b>COFACE</b>	French export credit agency
<b>DGIS</b>	Directorate General for International Co-operation (Netherlands)
<b>ECA</b>	Export credit agency
<b>EAI</b>	Enterprise for the Americas Initiative
<b>ECGD</b>	Export Credits Guarantee Department (UK)
<b>EcoFund</b>	Environmental Fund (Poland)
<b>EKN</b>	Swedish export credit agency
<b>EMTA</b>	Emerging Markets Traders Association
<b>ERG</b>	Swiss export credit agency
<b>FPE</b>	Foundation for the Philippine Environment
<b>GEF</b>	Global Environment Facility
<b>HIID</b>	Harvard Institute for International Development
<b>HIPC</b>	Heavily Indebted Poor Countries (debt initiative)
<b>IDA</b>	International Development Association (of the World Bank Group)
<b>IFESH</b>	International Foundation for Education and Self-Help
<b>IPG</b>	Interagency Planning Group on Environmental Funds
<b>IUCN</b>	World Conservation Union
<b>KfW</b>	German Development Bank
<b>LIBOR</b>	London interbank offered rate
<b>MEDA</b>	Mennonite Economic Development Associates
<b>NGO</b>	Non-governmental organisation
<b>NPV</b>	Net present value
<b>ODA</b>	Official development assistance
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>SCDO</b>	Swiss Coalition of Development Organisations
<b>SDR</b>	Special Drawing Rights
<b>SDRF</b>	Swiss Debt Reduction Facility
<b>SIDA</b>	Swedish International Development Agency
<b>SILIC</b>	Severely indebted low-income country
<b>TFCA</b>	Tropical Forest Conservation Act
<b>UNDP</b>	United Nations Development Programme
<b>UNICEF</b>	United Nations Children's Fund
<b>UNSO</b>	UNDP Office to Combat Desertification and Drought
<b>USAID</b>	United States Agency for International Development
<b>WWF</b>	World Wildlife Fund

## 1. BACKGROUND AND HISTORY

### Box 1.1 Debt swap

A debt swap involves the voluntary exchange, by a creditor with its debtor, of debt for cash, another asset or a new obligation with different repayment terms. The economic rationale for debt swaps is based on the willingness of a creditor to accept less than **face value** for debt and of the debtor to make payment at a higher value, but usually less than 100% of face value of the original debt. The terms **debt swap**, **conversion**, and **exchange** are often used interchangeably.

The international debt crisis of the 1980s led to the introduction of the debt swap mechanism for conversion of debt owed by developing countries that were unable to service their external debt. Chile was the first country to establish an institutionalised **debt-equity** swap programme in 1985. In a typical debt-equity swap, **commercial debt** owed by a developing country government (**sovereign debtor**) to a private sector creditor is purchased by an investor in the **secondary debt market** and is then converted into an equity investment in the debtor country. Debt-equity swaps have contributed to both debt reduction and increased investment in developing countries.

The debt swap mechanism was applied to the not-for-profit sector with the first **debt-for-nature** swap in Bolivia in 1987, which soon led to the introduction of **debt-for-development** swaps in other sectors such as child development, education and health. Although debt-for-development and debt-for-nature swaps have not been an important source of debt reduction in developing countries compared with debt-equity swaps, these transactions have generated significant funding for development projects.

Once considered new and innovative, debt swaps have become standard fare for debt managers in many developing countries over the past fifteen years. About fifty countries have implemented swaps in one form or another since 1985. In their first decade, the focus was on **three-party debt swaps** involving conversion of commercial debt or export credits. With the introduction of the **Paris Club debt swap clause** in 1990, **bilateral debt** also became eligible for swaps.

Debt owed to multilateral creditors has been excluded from swap operations because of the preferred creditor status of multilateral institutions. It could be argued that the **Heavily Indebted Poor Countries (HIPC)** Initiative involves de facto conversion of multilateral debt since the debtor country must be committed to a poverty reduction programme as a precondition for HIPC debt relief.

### 1.1 Conversion of commercial debt

<b>Table 1.1 Commercial debt prices selected countries (In percentage of face value, as of 19 July, 2000)</b>		
<b>Country/Issue</b>	<b>Bid</b>	<b>Offer</b>
Albania/Lcs, Promissory notes	15.500	18.250
Angola*/Loans-Banco Nacional Trade	10.000	13.000
Benin*/Loans, Promissory note	10.000	12.000
Bosnia/Series-A Bonds	21.000	21.625
Bulgaria/front loaded interest reduction bond	74.750	75.250
Burkina Faso*/Trade	12.000	15.000
Chad*/Trade	2.000	5.000
Cameroon*/Loans	13.000	15.000
Cape Verde/Trade	19.000	26.000
Central African Republic*/Trade	3.000	4.000
Congo*/Loans, US	11.500	13.250
Congo*/Trade	8.500	11.500
Cuba/Loans, Bank of Tokyo, Yen	6.500	8.000
Ecuador/IEB	26.740	32.000
Ecuador/Par	35.000	35.500
Egypt/Conversion Trade	49.750	51.000
Ethiopia*/Trade	6.000	11.000
Equatorial Guinea/Trade	21.000	27.000
Gambia/Trade	10.000	20.000
Ghana*/Trade	79.000	83.000
Guinea-Bissau*/Trade	6.000	10.000
Guinea (Conakry)*/Loans	8.000	13.000
Guyana*/Restructured Bonds, US	23.000	32.000
Honduras*/Loans, Trade	25.000	30.000
Kenya*/Trade	73.000	78.000
Laos*/Trade, US, Deutsche Mark, Yen	12.000	15.000
Liberia*/Loans, US	2.375	3.250
Libya/Trade-Central Bank	15.000	30.000
Madagascar*/Trade	22.000	28.000
Mali*/Trade	15.000	18.000
Mozambique*/commercial supplier/lender	11.000	14.000
Myanmar*/Trade, US, Japanese Yen	22.000	26.000
Nicaragua*/Loans, US	12.000	14.000
Peru/Par	42.500	45.500
Russia/PRIN	31.750	31.781
Senegal*/Loans, Trade	15.000	16.000
Sierra Leone/Trade	2.000	4.000
Sudan*/Loans, Citibank syndicate	3.250	3.625
Tanzania*/Loans, Trade	15.000	19.000
Uganda*/Trade	17.000	26.000
Venezuela/Debt conversion bond	82.875	83.250
Vietnam*/Past due interest	57.406	57.537
Zambia*/Loans, Trade	16.000	20.000
* HIPC Country		
N.B. 'Trade' refers to obligations that result from trade transactions, where the central government may have been guarantor, whereas 'loans' are generally owed to a commercial bank and result from a long-term credit agreement.		
Source: Wesbruin Capital, BradyNet		

Trading in sovereign debt increased substantially in 1986-87 after several debtor countries, primarily in Latin America, introduced debt-equity swap programmes as part of their **London Club** debt restructuring packages. Beginning in 1987, many commercial bank creditors also began to set aside reserves against their developing country debt exposure, enabling them to sell these loans at a **discount** from face value. The **Brady Plan**, introduced in 1989, stimulated further growth in the market as less liquid bank loans were exchanged for marketable securities called **Brady bonds**. The secondary market, now more commonly called the **emerging markets debt market**, continued to grow in the 1990s, peaking in 1997 with US\$6 trillion in trading volume, before declining to US\$2.2 trillion in 1999 in the aftermath of the Asian financial crisis.<sup>1</sup>

Commercial debt, including bonds, promissory notes and bank loans, is traded primarily by commercial and investment banks (so-called 'market-makers'), but market participants now include institutional investors (insurance companies, pension funds, etc.) and small 'boutique' firms that specialise in emerging markets debt. The market place for emerging markets debt is primarily an over-the-counter market composed of brokers, dealers and investors located

worldwide but linked informally through telecommunications contact and a network of broker screens.

<sup>1</sup> Emerging Markets Traders Association, 'Frequently Asked Questions: How large is the marketplace for Emerging Markets debt?' Web site: emta.org.

The **purchase price** for commercial debt is based on market forces of supply and demand which reflect traders' analysis of the perceived creditworthiness as well as the specific terms of the debt instrument. Although bonds for some countries are traded on a daily basis, so-called '**exotic**' debt is illiquid, which means that it trades infrequently and quoted debt prices may reflect a trade that took place a year or more before. Indicative debt prices for selected countries (mostly exotics) are listed in Table 1. Although debt that is priced at a substantial discount from face value by the market may be a good candidate for debt conversion, it may be difficult to purchase this debt if it trades infrequently.

The market continues to be dominated by trading in debt owed by Latin American countries (Brazil accounts for over 30% of the market). Much of this debt is no longer traded for debt-equity swaps since it is priced too high by the market because of the improved creditworthiness of Argentina, Brazil, Chile and Mexico, which no longer operate debt-equity swap programmes. These four countries accounted for 70% of all debt conversions between 1985 and 1994.<sup>2</sup>

At their peak, debt conversion transactions involving commercial debt reached US\$28 billion in 1990. By 1996, the last year for which complete statistics on debt conversion are available, only US\$900 million in commercial debt was converted, with only US\$100 million of debt-equity swaps and US\$800 million of **debt buy-backs** and **debt-for-debt** exchanges. From 1985 to 1996 a total of about US\$130 billion was swapped.<sup>3</sup>

Debt buy-backs and debt-for-debt exchanges now account for most conversion activity involving commercial debt. With support from the IDA Debt Reduction Facility, low-income countries have bought commercial debt back from their creditors, extinguishing US\$3.8 billion face value of commercial debt up to the end of 1999. The debt was exchanged for discounted payment in foreign currency, bonds, and, in some cases, a debt-equity (e.g., Senegal) or debt-for-development (e.g., Bolivia, Zambia) swap option. In 1999, Argentina, Brazil, Mexico, the Philippines and Uruguay retired US\$6.9 billion of Brady bonds through open-market debt buy-backs and discounted debt-for-debt exchanges.<sup>4</sup> Countries such as Ecuador, Pakistan and Russia have proposed unilateral exchange offers to bondholders to replace defaulted bonds with new obligations with longer repayment terms.

**Box 1.2 Countries with debt swap programmes for conversion of commercial debt**

Argentina	Mexico
Bolivia*	Morocco
Brazil	Mozambique*
Chile	Nigeria
Colombia	Philippines
Costa Rica	South Africa
Dominican Republic	Tanzania*
Ecuador	Uruguay
Ghana*	Venezuela
Guatemala	former Yugoslavia
Jamaica	Zambia*
Madagascar*	

\* HIPC countries

## 1.2 Debtor government debt swap programmes

Debt swaps can be negotiated by debtor governments either on a case-by-case basis or according to a set of guidelines which govern procedures for submitting a debt conversion application, granting an authorisation, tendering of

debt and payment of debt conversion proceeds. The guidelines generally define eligible investors and purposes and may set priorities in terms of the sector or geographical area where debt swap

<sup>2</sup> World Bank, 'World Debt Tables 1996 Analysis and Summary Tables', (Washington, DC: 1996), p. 88. Includes debt buy-backs and exchanges.

<sup>3</sup> World Bank, 'Global Development Finance 1998, Analysis and Summary Tables', (Washington, DC: 1998), p. 89.

<sup>4</sup> World Bank, 'Global Development Finance 2000, Analysis and Summary Tables', (Washington, DC: 2000), pp. 155-7.

proceeds may be invested. In the case of debt-equity swaps, they may also establish restrictions on profit remittance and capital repatriation.

Although **debt swap programmes** for conversion of debt owed to commercial creditors have been established by many developing countries in the past, few programmes are active today.<sup>5</sup> Nigeria's auction system for converting debt is one of the few programmes which are still active. As described above, prices for commercial debt owed by middle-income (and some low-income) countries have risen, resulting in reduced discounts for debt swap transactions. The peak in debt-equity swap activity in 1990 was linked to privatisation programmes, which have since turned to other instruments or are winding down. In addition, the implementation of Brady Plan debt restructuring agreements has enabled many debtor countries to manage their relations with creditors better and even return to international capital markets.

Many low-income countries have reduced amounts of commercial debt eligible for debt swaps because of commercial debt buy-backs and past debt swap programmes (e.g., Madagascar). Low-income countries may also be limited by the lack of domestic budgetary resources to fund a debt swap programme. Finally, in light of the HIPC Initiative, which offers the potential for substantial debt relief for eligible countries, debtor countries may postpone considering debt swap operations until the parameters for HIPC debt relief are established. Debt conversion has become less attractive for HIPC countries because there is little margin for converting debt if up to 90% of a country's bilateral and multilateral debt is being reduced (in **net present value – NPV**– terms).

### 1.3 Conversion of bilateral debt

Low-income countries are more likely to consider debt conversion in the context of bilateral debt reduction programmes. These programmes generally offer more significant debt reduction and greater investment in social sectors than other types of debt conversion. The introduction of the **Paris Club debt swap clause** in debt rescheduling agreements in the 1990s provided a framework for conversion of debt owed to bilateral creditors (**bilateral debt**). Based on the debt swap clause, Paris Club creditor governments established:

- **Debt reduction programmes** for conversion of Official Development Assistance (ODA) debts into funding for development and environmental projects. A few bilateral aid agencies have also bought debt back from export credit agencies or commercial creditors in the creditor country (e.g., Belgium, Switzerland) for use in bilateral debt reduction programmes.
- **Debt sales programmes** for conversion of non-concessional export credits – mostly for debt-equity swaps. In these programmes, the creditor government agency (usually an export credit agency (ECA) or Finance Ministry) sells debt to potential investors for debt conversion transactions. These programmes have experienced reduced sales for debt conversion transactions, similar to the decline in sales of commercial debt for debt-equity swaps.

**Non-Paris Club bilateral creditors** have also sold debt for debt swap transactions, generally through *ad hoc* transactions negotiated with investors or through bilateral agreements negotiated directly with debtor country governments.

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<sup>5</sup> Programmes in Ghana and Mexico are currently only for debt-for-development swaps. Nigeria's programme continues to be open for all types of conversion.

## 1.4 Contents of the overview

Most of the available information about debt swaps is from the perspective of potential investors or creditors. This overview provides a guide to debt swaps from the debtor country point of view, beginning with a brief discussion in chapter 2 of the advantages and disadvantages of debt swaps. Chapter 3 focuses on three types of debt swaps: debt-equity, debt-for-development and debt-for-nature swaps. As shown in Table 1.2 below, the debt swap mechanism has spawned several types of swaps. In its broadest definition, debt conversion also includes commercial debt buy-backs and debt-for-debt exchanges; however, they are not covered by this overview since they have been reviewed in other publications on debt management. Chapter 4 describes procedures and terms for negotiating three-party debt swaps, including the legal agreements that are typically necessary to implement a debt conversion. Chapter 5 provides additional information about bilateral debt reduction and debt sales programmes. Chapter 6 concludes with a discussion of future prospects for debt swaps.

All of the technical terms highlighted in the text in **bold** are defined in a Glossary of Terms found in Annex A. Annex B provides an annotated list of Additional Resources, both published documents and web sites. Annexes C and D summarise two creditor-sponsored debt reduction programmes.

<b>Table 1.2 Types of debt swaps</b>			
<b>Type of Debt Conversion</b>	<b>Parties to Transaction</b>	<b>Eligible Debt</b>	<b>Type and Use of Debt Conversion Proceeds</b>
<b>debt-equity</b>	<u>three-party</u> debtor government private sector investor <i>represented by bank</i> creditor <i>commercial</i> <i>export credit agency</i> <i>Ministry of Finance</i>	commercial debt <i>bank loans</i> <i>bonds</i> <i>promissory notes</i> <i>purchased on secondary debt market</i>  bilateral publicly guaranteed debt <i>export credits</i> <i>Paris Club &amp; non-Paris Club</i> <i>purchased from export credit agency (ECA)</i>	cash bonds <i>monetary stabilisation</i> <i>convertible debt conversion</i> public sector assets  private sector investment <i>equity shares</i> <i>fixed investment</i> <i>working capital</i> <i>privatised public enterprises</i>
<b>debt-for-development</b>  debt-for-child development debt-for-education debt-for-health debt-for-environment debt-for-nature	<u>three-party</u> debtor government not-for-profit investor <i>academic institution</i> <i>non-governmental organisation</i> <i>religious organisation</i> <i>United Nations agency</i> creditor	commercial debt  bilateral publicly guaranteed debt (small amounts)	cash bonds policy changes  funding for development projects  environmental fund
	<u>bilateral</u> debtor government <i>debt management agency</i> <i>sectoral ministry</i> creditor government <i>financial agency</i> <i>aid agency</i>	Official Development Assistance (ODA) debt  buy-backs of publicly guaranteed debt and tail-ends	cash (local currency)  funding for development projects counterpart fund environmental fund
<b>debt-for-exports</b>	<u>three-party</u> debtor government private sector investor creditor	commercial debt	local currency payment for exported goods <i>non-traditional exports</i>
	<u>bilateral</u> debtor government creditor government	bilateral debt	clearing arrangement <i>exports</i>
<b>debt-for-offsets</b>	<u>three-party</u> debtor government private sector investor creditor	commercial debt  domestic debt	offset against obligations to debtor government <i>taxes</i> <i>customs duties</i>
<b>debt buy-back</b>	debtor government commercial creditors  financed by IDA Debt Reduction Facility	commercial debt	cash (foreign currency) long-term bonds debt-equity bonds debt-for-development option
<b>debt-for-debt</b>	debtor government commercial creditors	commercial debt <i>Brady bonds</i>	domestic bonds

## 2. ADVANTAGES AND DISADVANTAGES OF DEBT SWAPS

### 2.1 Advantages

From the debtor government perspective, the principal advantages of debt conversion are:

**Debt reduction:** Debt conversion retires debt at a discount from face value, **also** expressed inversely as the **redemption price** or rate for the conversion. The lower the redemption price paid (or the higher the discount), the more debt reduction that is achieved through the conversion. Debtor countries seek to capture the largest share of the discount possible. Using NPV calculations, a debtor government can compare the impact of debt conversion with results generated by different debt relief scenarios. Repayment terms for debt conversion should be more favourable than anticipated renegotiated terms.

#### **Box 2.1 Potential advantages**

- debt reduction
- investment promotion
- return of flight capital
- channelling investment to priority areas
- support for privatisation
- support for development projects
- foreign exchange savings

Countries such as Chile and Mexico have been to retire a significant portion of their commercial debt through debt swaps. In Chile's case, the debt swap programme helped reduce the debt overhang, thereby hastening a return to international capital markets.

Through its debt-for-development programme, Mexico was able to retire costly Brady bonds with value recovery rights paying additional dividends in the event that revenues from oil exports exceed a certain level. In most countries, however, although debt swaps have made a contribution to debt reduction, their quantitative influence has remained limited relative to the volume of debt.

**Positive impact on the balance of payments:** By reducing debt service payments in foreign currency, debt swaps can have a positive impact on a country's balance of payments. The use of swaps to encourage exports may also improve the trade balance. In the case of debt-equity swaps, this positive impact may be reduced somewhat by future demand for foreign exchange for the repatriation of dividends, profits and capital. For countries with national currencies linked to a hard currency (e.g., CFA franc zone countries), there may be less benefit to replacing external debt with local currency obligations.

**Investment promotion:** Debt swaps can be structured to favour investment in priority sectors. For example, in Argentina, debt-equity swaps were permitted provided the local currency was invested in export-oriented investments and an equal amount of new foreign money was brought into the country. Other countries used debt-equity swaps as an incentive to encourage privatisation or to facilitate the return of flight capital by their nationals.

**Increased funding for development programmes:** Countries such as Mexico and Madagascar have favoured debt-for-development and debt-for-nature swaps, with both countries offering more attractive redemption rates for not-for-profit investors. In many countries, bilateral debt reduction programmes have stimulated the creation of local currency environmental or social funds, funding mechanisms with governance structures that are often new to the countries where they have been introduced. Both three-party and bilateral debt swaps generally lead to greater participation by civil society, including NGOs, in implementing development projects. Initial capital generated through debt-for-development swaps can also be used to attract matching contributions from other donors. For example, in Mexico, the Global Environment Facility (GEF) made a major contribution to a protected areas fund after the government had agreed to fund a multi-million dollar debt-for-nature swap. Finally, swaps can also generate positive publicity that raises the profile of development projects in the debtor country.

Debtor governments generally try to estimate the degree of **additionality** offered by debt conversion proposals by determining the likelihood of the foreign investment or development

assistance entering the country in the absence of debt conversion.

## 2.2 Disadvantages

There are also several potential disadvantages of debt swaps:

**Fiscal cost of prepayment of debt:** Since debt swaps usually require payment in local currency, one constraint to debt conversion may be the lack of fiscal resources to make what often amounts to a prepayment. Debt conversion may be less attractive for countries with large burdens of domestic debt, since it transforms an external into a domestic debt. The budgetary impact of debt conversion can be managed if payments are made over time.

### Box 2.2 Potential disadvantages

- Budgetary impact
- Risk of inflation
- Transaction costs
- 'Round-tripping'
- Policy conditionality
- Subsidisation of investment

**Inflationary risk:** A negative impact of debt conversion in some countries has been the injection of excessive amounts of local currency into the national economy resulting in inflation. This is one reason why debt conversion programmes in Latin America were suspended. In order to mitigate any adverse inflationary impact, debtor governments can place a ceiling on the amount of local currency paid through debt swaps and/or structure transactions with payment in instalments or bonds. It should also be noted that debt-equity swaps for the privatisation of public assets have no adverse monetary impact.

**Transaction costs:** Since debt swap transactions are complex and often time-consuming, government officials may need to devote significant resources to negotiating, documenting and monitoring transactions. In some cases, debtor governments have commissioned foreign financial advisers to assist them in implementing debt swap transactions. In order to cover some of their costs, many debtor governments have charged a transaction commission.

**Risk of corruption by investors:** It is important that the debtor country should monitor the use of debt conversion proceeds in order to prevent 'roundtripping', whereby investors transfer local currency generated through conversion out of the debtor country for illegal gain. This is one reason why some debtor governments have chosen to restrict participation by nationals in debt swap programmes. **Debt conversion agreements** can stipulate reporting requirements that enable the debtor government to monitor the use of debt conversion proceeds.

**Policy conditionality:** Debt swaps have been perceived in some countries (e.g., Brazil) as a challenge to national sovereignty because swaps often result in the transfer of local assets to foreign ownership or control (e.g. particularly in the case of debt-equity swaps for privatisation of public enterprises). Nationals of the debtor country have been precluded from participating in debt-equity swaps in some countries.

With the first debt-for-nature swap in Bolivia, conservation organisations learned that swaps linked to policy changes were difficult to implement and provoked controversy. As a result, there has been only one more debt-for-nature swap involving policy change by the debtor government (the creation of a marine reserve in Guinea-Bissau).

Conversion of bilateral debt has also raised the issue of policy conditionality since bilateral debt reduction agreements often require the beneficiary countries to meet macroeconomic and political criteria imposed by creditor governments in order to qualify.

***Subsidisation of investment:*** In the absence of additionality, the debtor government may be subsidising investment that would have occurred anyway. The literature on debt swaps seems to suggest that overall debt-equity swaps were a major incentive for foreign investment and a boost to privatisation programmes. It is important that the debtor government should attempt to measure the degree of additionality of investments and development projects funded through debt swaps.

### 3. TYPES OF DEBT SWAPS

#### 3.1 Debt-equity swaps

##### **Box 3.1 Debt-equity swap**

In a debt-equity swap, external debt of a developing country is converted into local currency funding for equity investment in that developing country. Typically, the investor (a bank or a private company) buys the debt at a discount from face value on the secondary market or from a bilateral export credit agency. The debtor government then redeems the debt at a negotiated value in local currency or local currency instruments (e.g., bonds) which are then used to invest in equity. In the context of privatisation programmes, debtor governments offer to exchange debt for public assets.

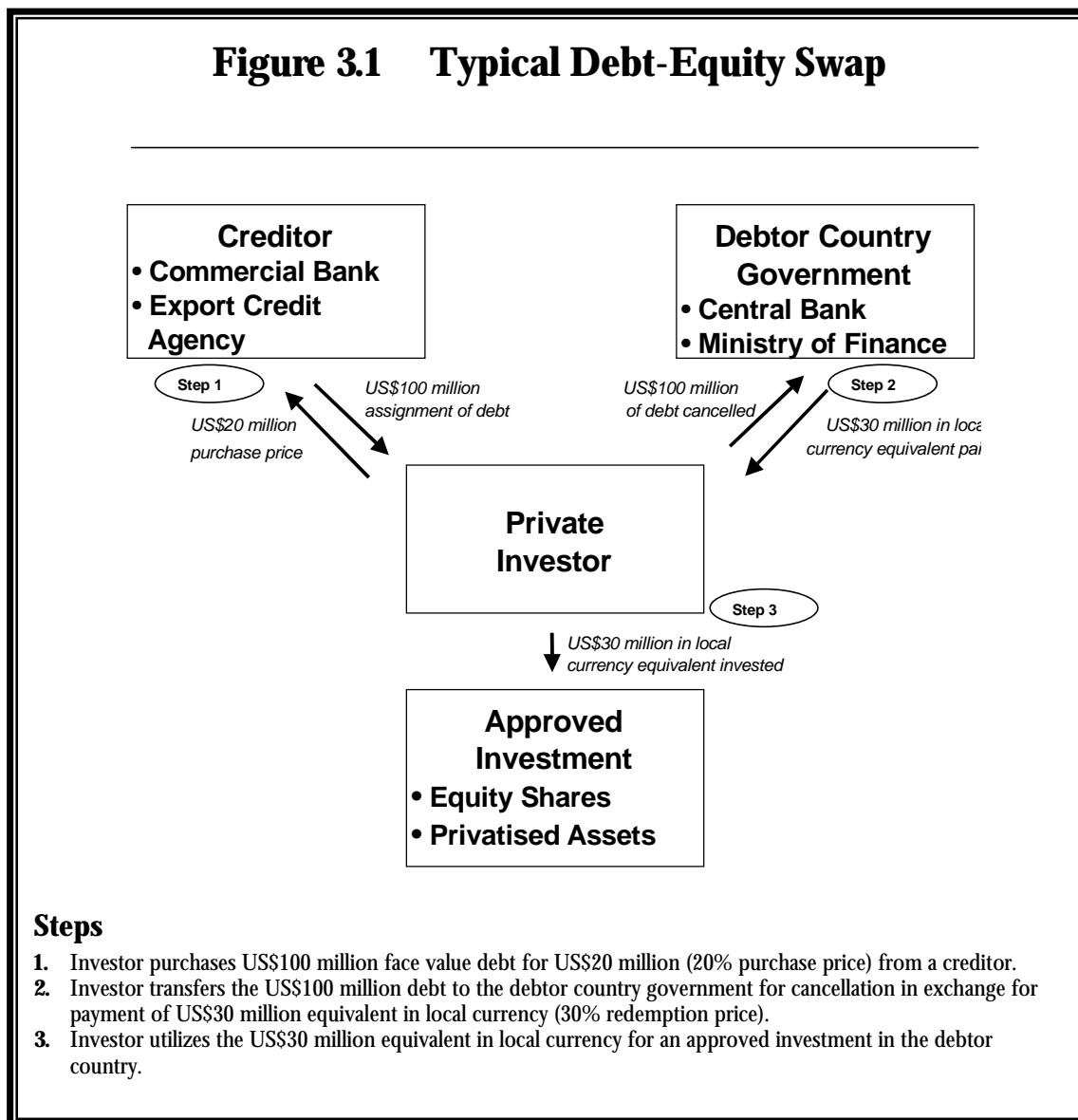
From 1985 to 1996, debt-equity swaps totalled US\$38.6 billion.<sup>6</sup> The linkage of debt-equity swaps to privatisation programmes stimulated increased swap transactions in 1989-90. As described above, debt-equity swaps declined substantially beginning in 1994 and most of the debt-equity swap programmes that existed in the 1980s have been suspended or no longer exist today. Nigeria appears to be the only country that continues to operate an active debt-equity swap programme, although countries such as Guinea, Mozambique and Senegal continue to engage in debt-equity swaps on a case-by-case basis.

The design of debt-equity swap programmes has reflected the primary objectives of these programmes – reduction and investment promotion. Some countries introduced auction systems for converting debt in order to capture the maximum discount of debt based on competing bids from investors. In order to attract investment, other countries imposed relatively few restrictions on foreign investors.

One of the main differences between debt-equity and other types of debt conversion is that private investors are likely to transfer funds out of the country in the form of dividends and capital repatriation. Debtor governments have typically limited such transfers (for example, only after 4 years for dividends and 10-12 years for capital). Some countries have also insisted that an

<sup>6</sup> World Bank. 'Global Development Finance 1998, Analysis and Summary Tables', (Washington, DC: 1998), p. 89.

investment should not be entirely financed through debt conversion and have established a percentage amount of ‘new money’ that must be brought into the country for the investment. An important issue is whether both foreigners and nationals are allowed to participate in debt-equity swaps. In some countries, only foreigners have been allowed to participate; in others, nationals were encouraged to participate on the grounds that swaps provide an incentive to repatriate flight capital. In countries with foreign exchange restrictions, nationals have usually



been restricted from participating because of concerns about ‘round-tripping’.

### Case study: debt-equity swaps for bank privatisation in Mexico

Countries such as Argentina, Mexico and the Philippines have used debt-equity swaps as a way to stimulate interest in privatisation programmes. As part of its 1990-93 debt-equity swap programme, in July 1990, the Mexican Government held a debt swap auction at which it offered to exchange inter-bank debt held by the six largest banks in Mexico for US\$1 billion of ten-year Federal bonds paying Libor plus 13/16. These bonds could then be exchanged at par for equity in the Mexican banks. The debt-for-bonds auction with a conversion option was oversubscribed

because of the attractiveness of converting the bonds into bank equity. As a result, the bond issue was increased from US\$1 billion to US\$1.15 billion. Investor interest was also reflected in the discounts demanded by creditor banks, which averaged only 1.6%. Participation in the auction was one way for foreign investors to obtain authorisation to own stock in the banks, which were considered a sound investment. The swap mechanism successfully reduced the outstanding debt of the Mexican banks, considered crucial to their subsequent privatisation.

### **Case study: Morocco's debt-equity swap programme for conversion of bilateral debt**

Morocco is one of the few countries that operated a debt-equity swap programme after 1995. Although a debt-equity swap programme was first introduced in 1993 for the conversion of rescheduled debt owed to commercial banks, rising secondary market prices for Morocco's debt limited the attractiveness of the initial programme. In 1996, the Government launched an offer to potential investors for a debt-equity swap programme to convert FF 600 million face value of debt owed by the Moroccan Government to the French Government. The programme was based on a bilateral agreement signed between France and Morocco implementing Morocco's February 1992 Paris Club agreement. A similar programme was subsequently established for debt owed to Spain.

The objective of the programme was to contribute to Moroccan economic and social development through increased French investment in Morocco. Eligible investments included capital investments in all economic sectors to finance a new project, extend an existing project, or purchase equity shares in Moroccan companies. The Moroccan Government evaluated investment proposals based on their contribution to job creation, local market expenditures and exports.

The programme was reserved for foreigners and Moroccans resident overseas (represented by a bank). While the investment proposal to the Moroccan Government required that the investor indicate the redemption price in Moroccan Dirhams, the French Government required the investor to submit an offer indicating a purchase price and including a letter from the Moroccan Government approving the investment. The French Treasury then accepted the highest bids from eligible investors. Although there are no statistics available regarding the debt converted through this programme, the Moroccan Government reportedly was pleased with the range of investment proposals generated by the programme.

## **3.2 Debt-for-development swaps**

### **Box 3.2 Debt-for-development swap**

In a typical debt-for-development swap, a development organisation (academic institution, non-governmental organisation (NGO) or UN agency) purchases sovereign debt at a discount. The NGO then negotiates with the debtor government to exchange the debt at par or at an agreed discount for local currency funding for a development project approved by the country and implemented by the development organisation. The terms debt-for-development and **debt-for-aid** are used interchangeably

Once the swap concept was established through debt-for nature swaps, development organisations working in other sectors actively engaged in debt swaps. Although conservation

organisations have been the most active participants in debt swaps (both three-party and bilateral), the broad definition of debt-for-development swaps includes not only debt-for-nature, but also **debt-for-child development**, **debt-for-education** and **debt-for-health swaps**. Most of the not-for-profit participants in swaps have been international organisations with the capacity to raise hard currency funding from bilateral and/or private donors. Donor agencies, such as the Canadian International Development Agency (CIDA), French Cooperation, DGIS (the Netherlands), the Swedish International Development Agency (SIDA), the United Nations Development Programme (UNDP) and the US Agency for International Development (USAID), have provided support for debt-for-development swaps. In order to access donor funding to invest in debt swaps, NGOs have generally been required to comply with donor supervision of the swap (e.g., according to USAID's debt-for-development guidelines), along with donor requirements relative to project implementation.

Typically, foreign organisations work with a local beneficiary that is responsible for managing the local currency proceeds and interacting with the debtor country financial authorities. Mexico is the only country where local not-for-profit organisations have been leaders in initiating debt swap transactions, without the assistance of a foreign organisation. Debtor governments monitor the development organisation's management of debt swap budgets in order to ensure that the funds are utilised according to expenditures budgeted in the debt swap proposal or application. In the case of Mexico, development organisations receive payment only upon presentation of receipts (after they have received a general authorisation to swap debt). In most cases, development organisations have relied on financial advisers to assist them in arranging swap transactions. For example, the USAID-supported NGO Finance for Development (originally the Debt-for-Development Coalition)<sup>7</sup> was instrumental in implementing swaps on behalf of US NGOs and also worked to raise awareness regarding the potential for debt-for-development swaps. *Association Conseil pour le Développement et l'Environnement* (ACDE) played a similar role for French NGOs<sup>8</sup>, as did the Mennonite Economic Development Associates (MEDA) in Canada. Banks and financial intermediaries, such as ING Bank<sup>9</sup> and New York Bay, have also specialised in implementing swaps for conservation and development organisations.

Compared to debt-equity swaps, debt-for-development and debt-for-nature swaps have not been a major contributor to debt reduction in developing countries. There are no comprehensive statistics on the amount of debt retired through these swaps. Finance for

### Box 3.3 Not-for-profit debt swappers

Africare  
 CARE  
 Catholic Relief Services  
 Christian Children's Fund  
 Christian Council of Zambia  
 Conservation International  
 Conservation Trust of Puerto Rico  
 Fund for Assistance, Promotion and Development (Mexico)  
 Habitat for Humanity  
 Harvard University  
 Harvest Help  
 Heifer Project International  
 IFESH  
 International Executive Service Corps  
 IUCN - the World Conservation Union  
 Missouri Botanical Gardens  
 Nigerian Conservation Foundation  
 Our Little Brothers and Sisters  
 Save the Children  
 The Sisters of Mary  
 Population Services International  
 River Blindness Foundation  
 Smithsonian Institution  
 UNICEF  
 World Vision  
 World Wildlife Fund

<sup>7</sup> The coalition ceased operations in 1996.

<sup>8</sup> ACDE reportedly arranged swaps in Cuba, Ecuador, Guinea (Conakry), Madagascar and Tanzania.

<sup>9</sup> Now ING Barings.

Development and New York Bay arranged swaps that collectively retired a total of US\$739 million of developing country debt from 1991 to mid-2000.<sup>10</sup> As described below, UNICEF was the single largest not-for-profit investor in debt-for-development swaps.

Both Bolivia (1993) and Zambia (1994) included a debt-for-development swap option on the menu of options for creditors in commercial debt buy-backs financed through the IDA Debt Reduction Facility. Under this option, creditors could choose to donate or sell debt to eligible not-for-profit organisations. The debtor governments then redeemed the debt at a premium to the buy-back price that was then paid in local currency in support of the approved development projects.

The development impact of debt-for-development and debt-for-nature swaps is difficult to assess since there has been almost no **monitoring and evaluation (M&E)** of these swaps. In many cases, donors have required M&E at the project level, but it is difficult to assess the additional development or debt reduction impact. The results of bilateral debt reduction programmes are easier to evaluate since creditor governments play a more direct role in their creation and they typically result in the creation of institutional structures such as **counterpart funds** or **environmental funds** that monitor grant-making programmes.

### **Case study: debt-for-development swap by UNICEF in Senegal**

From 1989 to 1995, UNICEF carried out 21 debt swap transactions converting a total of US\$199 million face value of debt into local currency funding of US\$52 million for programmes in support of child and maternal development.<sup>11</sup> Using **debt donations** and contributions from UNICEF Committees to purchase debt, UNICEF came close to doubling its development funds through debt swap transactions.

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<sup>10</sup> World Bank. 'Global Development Finance 1999,' (Washington, DC: 1999), Vol. 1, p.116, and New York Bay statistics for 1999-2000. Includes one debt-equity swap and swaps arranged for UNICEF Committees in Zambia.

<sup>11</sup> UNICEF's swap programme ended in 1995 reportedly because of UNICEF headquarters' desire to maintain more control over funding raised by UNICEF committees.

**Table 3.1 UNICEF debt-for-child development swaps**  
(thousands of US\$)

Country	Year	Sector	Face Value of Debt	Purchase Price of Debt	Development Funds Generated
Sudan	1989	Water	2,732	0	244
Sudan	1989	Water	2,732	0	225
Sudan	1989	Water	800	0	80
Sudan	1990	Water	7,023	0	801
Sudan	1991	Water	5,000	0	460
Sudan	1991	Water/Sanitation/Health	3,000	0	276
Sudan	1992	Water/Sanitation/Health	38,068	0	1,200
Jamaica	1992	Health/Street Children	4,000	2,877	4,000
Madagascar	1992	Health/Education/Nutrition	4,000	2,000	4,000
Philippines	1992	Children in Armed Conflict	486	245	329
Philippines	1993	Education	250	0	180
Philippines	1993	Education	1,226	864	1,000
Bolivia	1993	Education/Institutions	15,000	2,400	3,600
Madagascar	1993	Water/Education/Health	2,000	940	2,000
Senegal	1993	Water/Education/Health	24,000	6,000	11,000
Madagascar	1994	Emergency	2,000	1,000	2,000
Madagascar	1994	Water/Education/Health	1,200	576	950
Peru	1994	UNICEF Programmes	10,880	0	2,720
Zambia	1994	UNICEF Programmes	66,614	7,328	10,990
Mexico	1994	Health/Education	1,870	1,015	1,658
Mexico	1995	UNICEF Programmes	6,400	3,647	4,935
	<b>Total</b>		<b>199,281</b>	<b>28,892</b>	<b>52,648</b>

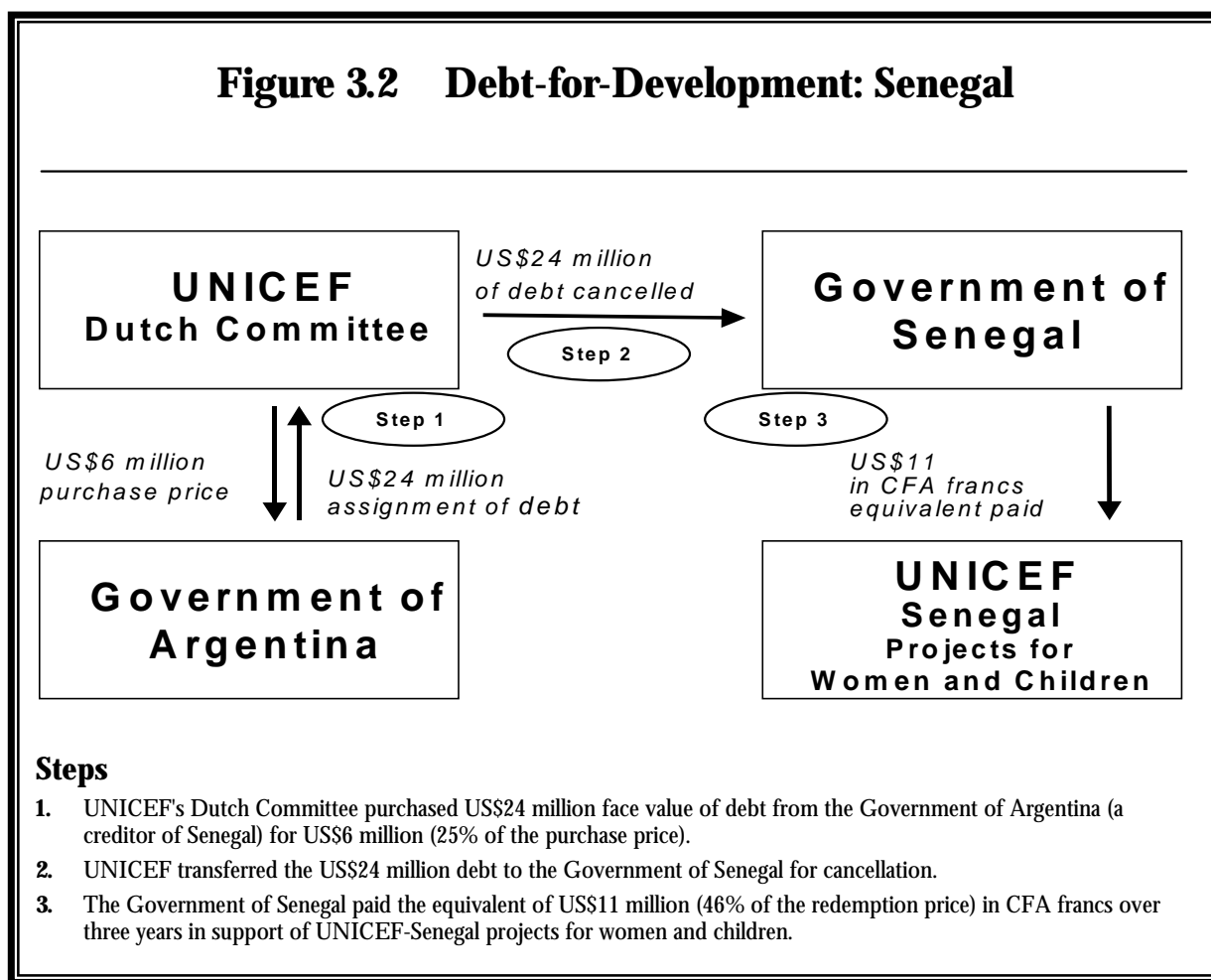
Source: UNICEF

It should be noted that in the early days of debt-for-development swaps, UNICEF and other not-for-profit debt swappers (particularly conservation organisations) were successful in persuading creditor banks to donate commercial debt because of the tax advantages and goodwill generated by debt donations.

In December 1993, UNICEF completed a debt-for-development swap in Senegal that was designed to fund education, health, sanitation and water projects throughout the country. With the assistance of ING Bank, UNICEF purchased US\$24 million face value of bilateral and commercial debt owed by Senegal to Argentina for a purchase price of US\$6 million (25% of face value). The Government of Senegal agreed to pay UNICEF the CFA franc equivalent of US\$11 million over three years to support UNICEF projects in Senegal.

In budgeting for the UNICEF swap, the Government of Senegal shifted funds budgeted for debt servicing and the health sector (the sector towards which most of UNICEF's expenditures were directed) to support the costs of the swap. In January 1994, one month after the debt swap agreement was signed, the CFA franc was devalued by 50%.

**Figure 3.2 Debt-for-Development: Senegal**



Since the CFA franc payments were pegged to the US dollar, the devaluation effectively doubled the Government of Senegal's payments in CFA francs. Subsequently, the Government of Senegal and UNICEF agreed to re-negotiate the terms of the transaction in order to minimise the budgetary impact of the increased CFA franc payments, while ensuring that the UNICEF programmes received the agreed level of support.

The UNICEF-Senegal swap is a good example of a swap involving non-Paris Club bilateral debt since debt owed to Argentina was not subject to a Paris Club rescheduling agreement. Once the debt was cancelled, Senegal was eligible for renewed cover from Argentina's export credit agency for exports from Argentina to Senegal.

### 3.3 Debt-for-nature swaps

#### Box 3.4 Debt-for-nature swap

A debt-for-nature swap involves the cancellation of external debt of a developing country in exchange for local currency funding for nature conservation and environmental protection in that country. Typically, a conservation organisation (generally an international NGO supported by funding from a bilateral aid agency) purchases sovereign debt at a discount in the secondary debt market or from a bilateral export credit agency (in some cases, commercial banks have donated debt). The conservation organisation then negotiates with the debtor country government for cancellation of the debt in exchange for payment in local currency or bonds. The local currency payment is then used to implement approved environmental activities. Bilateral creditors (Canada, Finland, Germany, USA) have also sponsored bilateral debt reduction programmes that have converted bilateral debt into funding for conservation and the environment.

Beginning with the first debt-for-nature swap in 1987, it is estimated that close to 30 countries have benefited from debt-for-nature swaps and bilateral debt reduction programmes. International conservation NGOs, such as Conservation International, the Nature Conservancy and the World Wildlife Fund, were pioneers in negotiating three-party debt-for-nature swaps with commercial creditors and debtor governments. At the time of the UN Conference on Environment and Development (Rio de Janeiro, 1992) creditor governments, such as Canada and Germany announced bilateral debt reduction programmes that reduced ODA debt in exchange for debtor government funding for environmental programmes. The USA had already introduced the Enterprise for the Americas Initiative (EAI) in 1990 (Annex D provides a summary of the EAI). As a result of these official debt conversions negotiated between creditor and debtor governments, environmental funds were established in many countries to channel funding to local organizations.

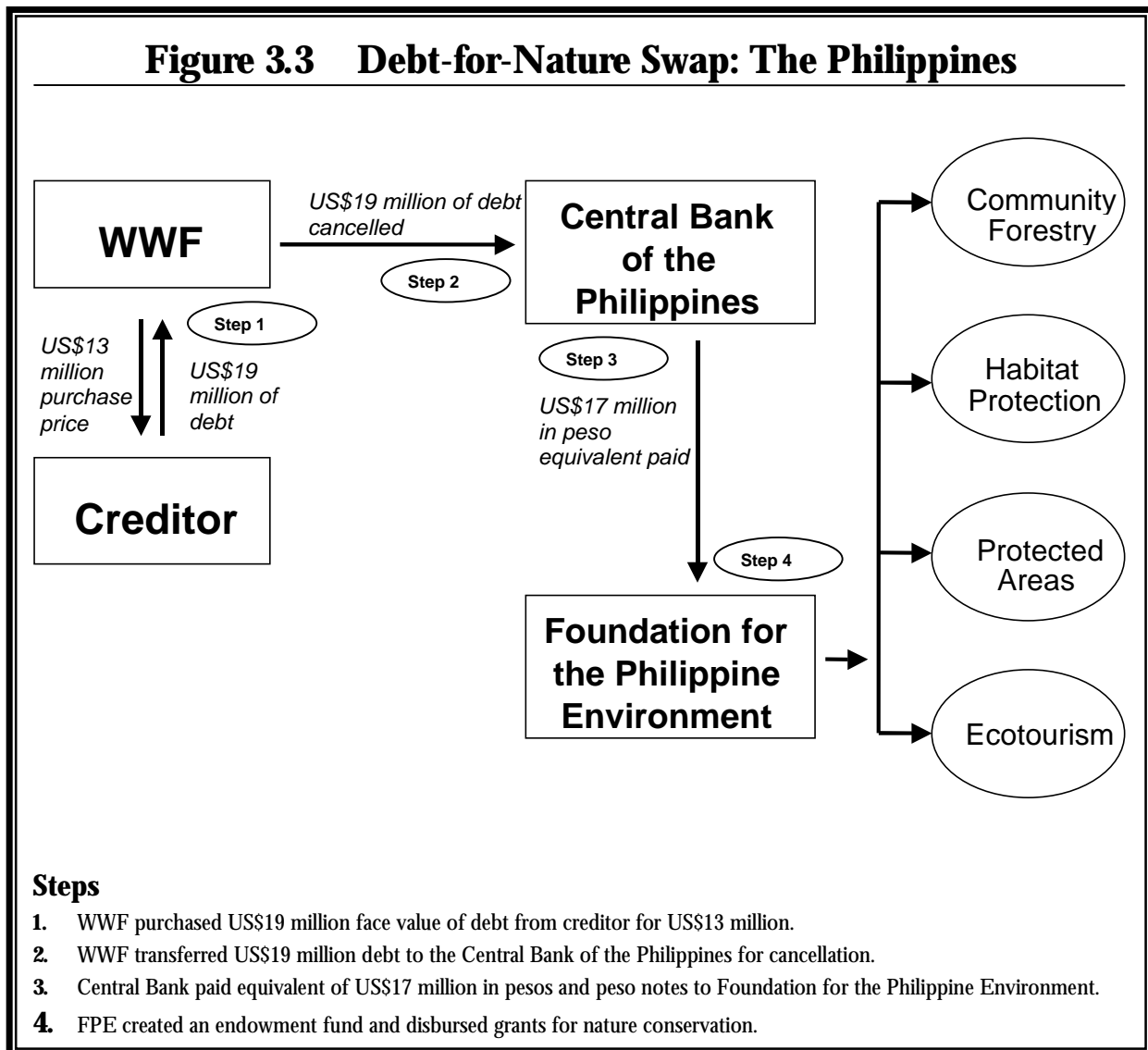
#### Box 3.5 First debt-for-nature swap in Bolivia

In 1987, Conservation International paid US\$100,000 to purchase US\$650,000 face value in debt owed by Bolivia to commercial creditors. In exchange for cancellation of the debt, the Government of Bolivia agreed to:

- establish a US\$250,000 operational fund for the management of the Beni Biosphere Reserve;
- strengthen the protected status of the reserve and adjoining areas

The case studies presented below describe two swaps that resulted in the creation of environmental funds. The Foundation for the Philippine Environment (FPE) is an example of an environmental fund that was capitalised through three-party debt-for-nature swaps. The Polish Environmental Fund (EcoFund) was established as a result of a multilateral agreement between the Government of Poland and its Paris Club creditors, confirmed in bilateral agreements negotiated with each participating creditor. The FPE is an example of an **endowment fund** whereas the EcoFund is a **sinking fund** that will disburse all of its resources over a designated period. In FPE's case, the debt swaps resulted in disbursement of Philippine pesos and peso bonds. The EcoFund is the only example of a debt-for-environment swap where the proceeds were paid in foreign currency.

**Figure 3.3 Debt-for-Nature Swap: The Philippines**



**Case study: Debt-for-Nature Swap for the Foundation for the Philippine Environment**

In 1993, the World Wildlife Fund (WWF) implemented a US\$19 million debt-for-nature swap in the Philippines. The 1993 swap was WWF's fourth swap in the Philippines since 1989. With funding of US\$13 million provided by USAID, WWF was able to purchase on the secondary debt market US\$19 million face value in Brady bonds owed by the Government of the Philippines. In other words, the purchase price for the debt was equivalent to 68% of the face value of the original debt. The Central Bank of the Philippines agreed to exchange the debt for Philippine pesos and peso notes with a value of US\$17 million or 90% of the face value of the debt (redemption price). By issuing notes in local currency, the Central Bank was able to contain any potential inflationary impact of the swap.

The US\$17 million proceeds have been used to ensure long-term funding for conservation and environmental projects through the creation of an endowment for the Foundation for the Philippine Environment (FPE). The objective of the FPE is to support the sustained management of natural resources and the preservation of biodiversity in the Philippines. The FPE provides funding, technical, managerial and other support to NGOs and other private and

public sector entities. In particular, the FPE serves as an institutional mechanism for empowering Philippine NGOs which have lacked resources for sustainable funding and technical assistance.

### **Case Study: Polish EcoFund**

The largest environmental swap to date involving conversion of bilateral debt was achieved through Poland's 1991 Paris Club debt restructuring agreement and resulted in the creation of the Polish EcoFund, an independent foundation, in 1992. Poland's Paris Club agreement cancelled 50% of Poland's Paris Club debt. In exchange for cancelling an additional 10% of each participating creditor's claims, Poland agreed to finance the EcoFund with an equivalent amount of hard currency funding drawn down from an escrow account at the Bank for International Settlements.

The hypothetical ceiling for the EcoFund is US\$3.3 billion; however, as of 1999, 5 out of 17 possible Paris Club creditors (France, Italy, Sweden, Switzerland, USA) had converted debt through the EcoFund. Funding of US\$545 million will be available for EcoFund grants from 1992 to 2010. The US contribution accounted for 72% of the total. The EcoFund finances private sector investment projects in four target categories: reducing trans-boundary air pollution, reducing pollution in the Baltic Sea, lowering greenhouse gas emissions and protecting Poland's biodiversity.

### **3.4 Other types of debt conversion**

**Debt-for-exports** transactions have generated local currency funding for the purchase of exports. In Peru, debt-for-exports transactions were used to promote non-traditional exports. In former Eastern Bloc countries, it has been common practice for bilateral governments to establish clearing arrangements whereby debt is reduced in exchange for local goods and services which are shipped to the creditor country. Hungary reportedly has had clearing arrangements with Mozambique, Russia and Vietnam.

In **debt-for-offsets** transactions, sovereign debt is offset against an investor's obligations to the debtor government (e.g. taxes, customs duties). In a debt-for-offsets transaction, an investor buys debt in order to offset it against obligations the investor owes to the debtor government.

## **4. PROCEDURES AND TERMS FOR NEGOTIATING THREE-PARTY DEBT SWAPS**

A three-party debt swap typically involves negotiations between an investor, a creditor and a debtor government.

- 1) between the investor (commercial or not-for-profit) and the creditor resulting in a **debt purchase agreement**; and,
- 2) between the investor and the debtor government resulting in a **debt conversion agreement**.

The investor will usually enter into exploratory discussions with the creditor and the debtor

government simultaneously, and will only conclude a debt purchase agreement<sup>12</sup> with the creditor when it has agreed debt swap terms with the debtor government. From the investor's point of view, the gain from debt conversion is the difference between the purchase price for the debt and the redemption price for the conversion. Pricing for a debt conversion is sometimes subject to interpretation when the conversion involves payment in a non-monetary asset or equity in privatised public enterprises.

Often, the debtor government will not be aware of the terms for the debt purchase, although it may have a good idea of the potential pricing for its debt based on rescheduling terms for bilateral debt and/or secondary market or buy-back prices for commercial debt. Some debtor governments have established a redemption price for debt conversion based on a set percentage above the purchase price for the debt.

## 4.1 Debt purchase agreement

### Box 4.1 Debt purchase (assignment) agreement terms

- name of obligor
- amount and type (e.g., principal, interest) of debt
- purchase price
- conditions for payment of interest
- conditions for closing (date, payment account)
- 'unwind clause' in the event the swap is not completed

The investor identifies potential debt to be converted and submits a bid to a creditor for purchase of the debt at a discount from the face value of the original debt. The investor is usually represented by a bank or other financial intermediary specialised in debt conversion transactions. Frequently, the

intermediary will purchase debt on behalf of the investor. Commercial debt that trades frequently on the secondary debt market is much easier to purchase. In general, prices for traded commercial debt have been higher than prices quoted by export credit agencies. Some creditors (e.g. export credit agencies) will require the debtor government to confirm that the debt is eligible for conversion. On the closing date, payment is made in exchange for assignment of the debt.

## 4.2 Debt conversion agreement

The following steps are involved in completing a debt conversion:

- the investor submits a debt conversion proposal or application to the debtor government, including the following information:
  - description of the applicant
  - description of the project to be funded with the debt conversion proceeds
  - project budget and schedule for payments
  - funding sources
  - terms for debt conversion;
- the debtor government negotiates the debt conversion terms with the investor;
- the debtor government authorises the debt conversion and signs a debt conversion agreement with the investor describing the terms of the agreement;
- the investor tenders the debt being converted to the debtor government for cancellation;

<sup>12</sup> Also called an assignment agreement.

- the debtor government performs under the terms of the debt conversion agreement by paying the debt conversion proceeds (usually into a commercial bank account or a designated account at the Central Bank);
- the investor uses the debt conversion proceeds for the agreed purpose;
- the debtor government monitors investor compliance with the terms of the debt conversion.

**Box 4.2 Debt conversion terms**

- amount and type of debt to be converted
- redemption price
- form the debt swap proceeds will take (e.g., cash, bonds, etc.)
- applicable exchange rate
- debtor government tax treatment or commissions
- schedule and procedures for debtor government payment
- legal documentation required
- investor terms for utilisation of debt conversion proceeds
- rules on repatriation of dividends (debt-equity)
- procedures for debtor government monitoring of investor compliance with the debt conversion terms (e.g., quarterly reports of expenditures)

From the debtor government's point of view a successful debt conversion negotiation should yield:

- a debt conversion agreement with a reputable investor;
- better repayment terms than other types of debt relief;
- the conversion of costly debt or debt not eligible for debt cancellation;
- a low redemption price for payment of debt conversion proceeds;
- foreign exchange rate based on each payment date if payment is made over time;<sup>13</sup>
- conversion for a high priority investment with a high degree of additionality; and
- procedures for monitoring the appropriate use of debt conversion proceeds.

## **5. BILATERAL DEBT REDUCTION AND DEBT SALES PROGRAMMES**

### **5.1 Paris Club creditors**

Paris Club creditors introduced the possibility of debt swaps for debt covered by Paris Club rescheduling agreements beginning with the Houston Terms in September 1990. The debt swap clause included in most Paris Club agreed minutes since then allows creditors to sell or exchange their claims in the framework of debt-for-aid, debt-for-nature, debt-equity or other local currency swaps. Participation in swaps is voluntary for creditor governments and is ratified by each creditor government in Paris Club bilateral agreements. The debt swap provisions have been incorporated into all subsequent Paris Club terms and also included in special debt restructuring arrangements agreed with Egypt and Poland.

All of ODA debt is eligible for swaps. The Paris Club has placed limits on the conversion of non-ODA debt. These were originally 10% or US\$10 million (whichever amount is higher) for each

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<sup>13</sup> The standard term is usually that the foreign exchange rate for the conversion will be the market rate prevailing on the closing date of the conversion.

**Box 5.1 Typical Paris Club debt swap clause**

On a voluntary and bilateral basis, the Government of each Participant Creditor country or its appropriate institutions may sell or exchange, in the framework of debt for nature, debt for aid, debt for equity swaps or other local currency swaps:

1. the amounts of outstanding loans as regards ODA loans;
2. the amounts of other outstanding credits, loans and consolidations, up to 20% of the amounts of outstanding credits as of [date] or up to an amount of SDR30 million, whichever is higher.

creditor. The ceiling was increased to 20% or SDR30 million per creditor in 1996. Most recently, the Paris Club agreed that the ceiling may be as high as 30% or up to SDR40 million in exceptional circumstances (adopted in the 1999 Cologne Terms).

Based on data compiled by the Paris Club Secretariat, an estimated US\$4.2 billion face value was swapped by Paris Club bilateral creditors by end-September 1999. Debt-equity swaps

accounted for US\$2.2 billion of the total and US\$1.6 billion was in the form of debt-for-development and debt-for-nature swaps. Among debtor countries, Egypt had the largest share of swaps totalling US\$1.7 billion or 40% of total swaps. Creditor countries implementing swaps included France (US\$1.4 billion – debt-equity and debt-for-development), Switzerland (US\$900 million – only debt-for-development), Spain (US\$400 million – only debt-equity), Belgium (US\$300 million – debt-equity and debt-for-development) and Germany (US\$300 million – debt-equity and debt-for-development).<sup>14</sup> Creditor countries such as Canada, Finland, Italy, the Netherlands, and the USA only completed debt-for-development/nature swaps, while the United Kingdom only sold debt for debt-equity or debt-for-development swaps. Sweden implemented both debt-equity and debt-for-development/nature swaps. Some creditor countries have not participated in debt swap transactions because of the lack of a legal framework or budgetary allocations for debt swaps.

As described below, Paris Club creditors have introduced two types of debt conversion programmes based primarily on the type of debt involved.

## 5.2 Paris Club debt reduction programmes

The Paris Club allows for the conversion of 100% of ODA debt included in rescheduling agreements. In bilateral debt reduction programmes, the creditor government agrees to reduce a developing country's ODA debt in exchange for debtor government support for development and/or environmental programmes. The creditor and debtor governments directly negotiate the terms of the debt reduction and the debtor government's commitment to set aside counterpart funds. Although non-governmental actors are not officially parties to the negotiations, quite often they play a substantial role in establishing priorities and determining how the conversion funds generated will be spent. The key terms to negotiate in a bilateral debt reduction agreement are:

- the redemption rate: the percentage of the face value of the debt that must be paid back in local currency;
- the schedule and procedures for repayment;
- the sectors to be funded through the conversion; and
- the funding mechanism and modalities for payment (e.g., counterpart funds).

<sup>14</sup> World Bank, 'Global Development Finance 2000, Analysis and Summary Tables', (Washington, DC: 2000), p. 173.

The Swiss Debt Reduction Facility (SDRF) (described in Annex C) and the US Enterprise for the Americas and Tropical Forest Conservation Act (described in Annex D) are examples of bilateral debt reduction programmes.

### **5.3 Paris Club debt sales programmes**

Several European creditors have debt sales programmes primarily for the conversion of guaranteed export credit loans, which operate subject to limits imposed in the debt swap clause. Under debt sales programmes, third party investors (both private investors for debt-equity swaps and not-for-profit organisations in the case of debt-for-nature and debt-for-development conversions) purchase debt from the creditor country export credit agency or other financial authority responsible for public or publicly-guaranteed debt.

The creditor country financial authorities assess the value of the debt to be converted based on the NPV of rescheduled debt and economic and market-based risk criteria. Sometimes creditors will be willing to discount debt further if they can ‘exit’ from administering small amounts of debt for a particular country or if the relevant debt is considered to be a special situation (e.g., the debt is contentious, former Eastern Bloc debt).

Creditors such as France and the UK have utilised market-based ‘auction’ mechanisms for selecting investors in debt conversions, while Belgium, Germany and Sweden are prepared to consider proposals on a case-by-case basis. Generally all bilateral creditors require the investor to demonstrate that the debtor government has agreed to the debt conversion prior to finalising a debt purchase agreement.

### **5.4 Non-Paris Club bilateral creditors**

As described above, non-Paris Club creditors, such as Hungary (debt-for-exports) and Argentina (debt-for-development) have converted debt owed by developing country governments. Most of the evidence of debt conversion by non-Paris Club creditors is difficult to confirm since the bilateral agreements are often not publicised.

China has converted debt into equity in African countries (e.g., Mali); however, since debt owed to China is often rolled over indefinitely, there may be little incentive to convert this debt. On the other hand, debtor countries may be interested in converting Chinese debt in order to benefit from the additional Chinese investment that may result from debt-equity transactions.

Prior to joining the Paris Club, Russia sold debt for a debt-equity swap in Tanzania. It also accepted in-kind payment in the form of payment of Embassy expenses in debtor countries.

<b>Table 5.1 Paris Club creditor debt reduction and debt sales programmes</b>				
<b>Creditor Programme</b>	<b>Eligible Debt</b>	<b>Swaps Completed in Debtor Countries</b>	<b>Use of Debt Swap Proceeds</b>	<b>Additional Information</b>
<b>BELGIUM</b>				
Ducroire/ Delcredere (ECA) debt sales	export credits	Egypt, Madagascar, Nigeria, Tanzania	sales for debt- equity and debt-for- development swaps	Sales for debt-for- development swaps listed below
Administration for Development Cooperation  debt-for- development	buy-backs of export credits from Delcredere and tail ends from commercial creditors	Benin, Bolivia, Cameroon, Congo, Côte d'Ivoire, Ecuador, Ethiopia, Guinea, Mozambique, Sierra Leone, Tanzania, Togo, Vietnam, Zambia	social development programmes, some counterpart funds established	
<b>CANADA</b>				
Canadian International Development Agency (CIDA)  Debt Conversion Initiative for Environment and Development	ODA debt	1993-97 Colombia, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, Peru	environment and sustainable development projects  bilateral trust funds established	Conversion of up to C\$145 million FV authorised  C\$123.5 million FV cancelled generating C\$64.7 million in local currency funds (as of 11/97)
<b>FINLAND</b>				
Ministry of Foreign Affairs		Peru (1995)	Nature and social development projects, biodiversity research project at Machu Picchu	US\$24.5 FV million cancelled in exchange for US\$6.4 million counterpart fund
<b>FRANCE</b>				
Agence française de développement  Libreville Fund <i>Fonds de conversion de créances pour le développement</i>	ODA debt and export credits	Cameroon, Congo, Côte d'Ivoire, Gabon	productive activities, local development, social projects, environmental protection, privatisation public sector restructuring, staff reduction, training	FF 4 billion eligible  conditional cancellation based on government counterpart funding for projects
Polish EcoFund		Poland (1993)	environment	1% of debt = US\$48 million
COFACE (ECA)/ French Treasury debt sales	export credits	Egypt, Honduras, Jordan, Morocco, Philippines, Tanzania	sales mostly for equity investments transactions based on auction system	By end-September 1999, France had converted US\$1.4 billion for all types.

<b>Table 5.1 Paris Club creditor debt reduction and debt sales programmes</b>				
<b>Creditor Programme</b>	<b>Eligible Debt</b>	<b>Swaps Completed in Debtor Countries</b>	<b>Use of Debt Swap Proceeds</b>	<b>Additional Information</b>
<b>GERMANY</b>				
Ministry for Economic Co-operation and Development (BMZ) and the German Development Bank (KfW)  Debt conversion programme	ODA	Bolivia, Côte d'Ivoire, Congo, Ecuador, Jordan, Honduras, Peru, Vietnam	education, environment and natural resources, poverty alleviation	Funding for programme allocated by German Bundestag each year
Ministry of Finance /Hermes (ECA)  debt sales	export credits	Egypt, Tanzania	sales mostly for debt-equity	
<b>ITALY</b>				
debt-for-environment Polish EcoFund		Poland	environmental protection and biodiversity conservation	
<b>NETHERLANDS</b>				
debt-for-development and environment	ODA debt  commercial debt bought back from private creditors	Chile, Costa Rica, Jamaica, Madagascar, Pakistan, Tunisia	Mostly conservation and environment	
<b>RUSSIA</b>				
debt-equity		Tanzania (1994)	investment in Sheraton Hotel	
<b>SPAIN</b>				
Ministry of Economy and Finance  debt sales	export credits	Egypt, Morocco Nigeria	sales for debt-equity	
<b>SWEDEN</b>				
EKN (ECA)  debt sales	export credits	Egypt, Nigeria	sales for debt-equity and debt-for-development	
debt-for-environment/ aid  Polish EcoFund		Tunisia, Costa Rica  Poland (1997)	environmental protection and biodiversity conservation	2% of Poland's debt cancelled US\$6.5 million to be paid

<b>Table 5.1 Paris Club creditor debt reduction and debt sales programmes</b>				
<b>Creditor Programme</b>	<b>Eligible Debt</b>	<b>Swaps Completed in Debtor Countries</b>	<b>Use of Debt Swap Proceeds</b>	<b>Additional Information</b>
<b>SWITZERLAND</b>				
State Secretariat for Economic Affairs  Swiss Agency for Development and Cooperation  Swiss Coalition of Development Organisations (plays active role)  Debt Reduction Facility	export credits  1992-93 buy-backs of uninsured portion ('tail ends') of officially guaranteed export credits	<u>As of August, 1998:</u> Bolivia, Côte d'Ivoire, Egypt, Ecuador, Guinea, Honduras, Jordan, Peru, Philippines, Senegal, Tanzania, Zambia  10 additional operations planned for eligible countries	<u>Priority Projects</u> social services and infrastructure, promotion of small industries, environment and natural resources, agriculture/fisheries	Debt cancelled equals SFr. 1,056.2 million FV for 12 countries  Local currency generated for counterpart funds totals SFr. 266.9 million.  Largest operations have been in Peru and Côte d'Ivoire
Ecofund		Poland (1993)	environmental protection and biodiversity conservation	10% of debt amounting to US\$52 million cancelled and available for grants
<b>UNITED KINGDOM</b>				
Export Credits Guarantee Department (ECGD)  debt sales	export credits	Sales in Egypt, Nigeria, Mozambique, Tanzania  over 30 eligible countries	sales for debt-equity and debt-for-development	Programme began in 1992. Guidelines revised in 1998.
<b>USA</b>				
US Treasury  Enterprise for the Americas (EAI)	ODA debt owed to USAID, PL-480	1991-93 Argentina, Bolivia, Chile, Colombia, El Salvador, Jamaica, Uruguay Peru (buy-back - 1998)	environment child survival	1991-93 US\$ 875 million FV retired; US\$154 million local currency interest stream
Tropical Forest Conservation Act (TFCA)	ODA debt owed to USAID, PL-480		tropical forest conservation	US\$325 million in Congressional appropriations authorised, 3 years; FY 2000 budget appropriated US\$13 million
EcoFund		Poland (1991)	environmental protection and biodiversity conservation	10% of debt cancelled = US\$367 million

## 6. FUTURE PROSPECTS FOR DEBT SWAPS

With the decline in debt-equity and debt-for-development swap activity in recent years, it is reasonable to ask whether these types of swaps are still an attractive option for debtor countries. Some critics have contended that debt swaps have been a failure because their contribution to debt reduction has been negligible. Experience over the years has shown that debt-equity and debt-for-development swaps have been most effective when they have been perceived as a tool to accomplish specific objectives rather than as a panacea to solve a country's debt problem. Unlike the HIPC Initiative, which provides a comprehensive framework for debt relief, debt swaps have typically had more limited objectives. As the case studies above have shown, these ranged from the privatisation of Mexico's banking system to support for environmental protection and social development through the establishment of environmental funds and counterpart funds. Swaps have also been used to convert special categories of debt (e.g., non-Paris Club debt). Most recently, in Asia, debt-equity swaps have been introduced for conversion of private sector debt.

Debt-for-development swaps can be credited with establishing the link between debt relief and increased funding for development projects. For example, the Swiss national debt campaign on the occasion of the 700th anniversary of the Swiss Confederation (1989-90) was an early 'jubilee' year, a precursor to the Jubilee 2000 campaign for expanded HIPC debt relief.<sup>15</sup> The Swiss introduced the concept of 'creative debt relief' which aims to pass the macroeconomic benefits of debt relief on to poor people at the 'micro' level. This increased focus on poverty alleviation was also later incorporated into Germany's bilateral debt swap programme.

In some SILIC countries, debt swaps have been eclipsed by the HIPC Initiative, which has had a major impact on the feasibility of implementing debt swaps. As bilateral creditor countries devote more resources to HIPC operations (both in the context of the Paris Club and of multilateral debt relief), they are less likely to have budgetary resources available for bilateral debt conversion programmes. Debtor countries may also be reluctant to agree to a debt swap (even with a substantial discount) if HIPC debt sustainability criteria continue to evolve, raising hopes for future increased debt relief.

### *When are debt swaps appropriate?*

Some basic principles for implementing debt swaps are recommended.

- **Debt swaps are best designed as part of a country's overall debt management strategy.** Through NPV analysis, the debtor government can review potential restructuring terms for different categories of debt and identify debt that may be suitable for conversion.
- **Debt swaps are most effective when they support a country's investment priorities and are used to attract "additional" investment to the country.** For low-income countries, these priorities are more likely to favour debt-for-development swaps for development and poverty reduction programmes, whereas middle-income countries may wish to consider swaps designed to attract private investment.

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<sup>15</sup> The idea of the jubilee year comes from the Old Testament when slaves were freed and debts cancelled so as to allow a fresh start for those who have been deprived.

- **Debt swaps require co-ordination among debtor country government agencies.** The debtor country's debt management agency generally plays a lead role in negotiating swaps, but this agency will need to work with planning and sectoral ministries in order to analyse the macroeconomic impact and micro-level results to be achieved through swaps.
- **Debt swaps can be designed to promote participation by civil society in funding and administering development programmes.** Debtor governments can play a role in designing governance structures for counterpart and environmental funds that allow for participation by civil society, while putting in place monitoring and evaluation systems to ensure accountability.

## ANNEX A – GLOSSARY OF TERMS

**Additionality:** New investment generated through debt conversion. Debt-equity swaps can be used to promote foreign investment in priority sectors of the economy and to stimulate privatisation or non-traditional exports. Debt-for-development swaps can attract additional donor assistance.

**Bilateral debt conversion agreement:** A legal agreement between a debtor government and a creditor government regarding the conversion of debt.

**Bilateral debt reduction programme:** A creditor government-sponsored programme to reduce developing country debt, which often includes debt conversion.

**Bilateral debt sales programme:** A creditor government-sponsored programme for the sale of rescheduled debt owed by a debtor government.

**Bilateral (official) debt:** Loans owed to bilateral creditor governments. Official Development Assistance (ODA) loans are typically owed to government aid agencies. Publicly guaranteed loans (mostly export credits) are owed to export credit agencies (ECAs).

**Brady bonds:** Securities that have resulted from the exchange of commercial bank loans for new bonds in the framework of the **Brady Plan** launched in 1989. Debt restructuring operations under the Brady plan resulted in the issuance of US\$160 billion face value of Brady bonds by Argentina, Brazil, Bulgaria, Costa Rica, Côte d'Ivoire, the Dominican Republic, Ecuador, Jordan, Mexico, Nigeria, Panama, Peru, the Philippines, Poland, Russia, Uruguay, Venezuela and Vietnam.

**Commercial (private) debt:** Debt owed to private sector creditors, including commercial banks, bond holders, and export and trading companies. Includes bonds, loans and promissory notes.

**Counterpart fund:** In exchange for debt cancellation, a debtor government agrees to redeem a part of the debt cancelled in local currency, which it pays into a counterpart fund. The legal framework for counterpart funds has typically been established through bilateral debt reduction agreements negotiated between creditor and debtor countries. They are most often governed by representatives of both civil society (local NGOs or other private institutions) and governmental institutions. The resources held in a counterpart fund are used to finance development activities and to strengthen the capacity of local organisations. They may also help to establish sustainable financing mechanisms such as loan guarantee funds.

**Debt buy-back:** The repurchase by a debtor government of all or a portion of its external debt at a discount from face value. The World Bank's IDA Debt Reduction Facility (funded by the IBRD and bilateral donors) has financed commercial debt buy-backs for low-income countries. Some creditor government have also sponsored buy-backs of officially guaranteed export credits from export credit agencies or the un-guaranteed portion of such credits (called '**tail-ends**') from exporters and banks for conversion through bilateral debt reduction programmes (e.g., the Belgian and Swiss programmes).

**Debt conversion agreement:** A legal agreement between the investor and the debtor government describing the terms, procedures and obligations of both parties to a debt conversion. In conversion involving bilateral debt, the agreement is between the creditor government and the debtor government.

**Debt-for-child development swap:** Debt-for-development swaps funding programmes benefiting children. UNICEF was the leader in implementing these swaps.

**Debt-for-debt swap:** The exchange of one type of debt for another type with different terms.

**Debt-for-development swap:** The cancellation of external debt in exchange for funding for development projects (child development, conservation/environment, education, health, etc.) in the debtor country. Also called **debt-for-aid**.

**Debt donation:** A creditor agrees to donate debt to a not-for-profit investor in debt swaps.

**Debt-for-education swap:** Debt-for-development swaps funding programmes benefiting education. Scholarship programmes for Latin American students were funded through debt-for-education swaps.

**Debt-equity swap:** The cancellation of external debt in exchange for equity investment in a domestic company or privatised public enterprise.

**Debt-for-exports swap:** The cancellation of external debt in exchange for local currency to purchase goods of the debtor country for export.

**Debt-for-health swap:** Debt-for-development swaps for health programmes. For example, the River Blindness Foundation increased its funding for river blindness eradication in Nigeria through debt-for-health swaps. The HIID recently argued that additional resources from debt relief should be directed to HIV/AIDs prevention.

**Debt-for-nature (environment) swap:** The cancellation of external debt in exchange for local currency that is used to finance conservation or environmental protection projects.

**Debt offset:** Purchase of debt by an investor to offset obligations (e.g., customs duties, taxes) owed to a debtor government.

**Debt purchase (assignment) agreement:** A legal agreement between an investor in a debt swap and a creditor (commercial or export credit agency) for the purchase of debt for conversion purposes. The creditor agrees to **assign** the debt to the investor.

**Debt swap (conversion, exchange):** The cancellation of external debt, typically at a discount from face value, in exchange for payment in local currency or another asset (bonds, privatised public assets, etc.). The terms 'conversion', 'exchange' and 'swap' are used interchangeably.

**Debt swap programme:** Programme officially sponsored by debtor or creditor country for the conversion of debt, generally involving the issuance of programme guidelines.

**Discount ('haircut') from face value:** Percentage of reduction from the face value of debt. The inverse of the discount is the **purchase price** or the **redemption price**. Also referred to in colloquial terms as the 'haircut'.

**Emerging markets debt market:** Also called the **secondary debt market** for trading of commercial debt owed by developing country governments. **Emerging markets** refer to low- and middle-income countries that are pursuing political and economic reforms and a more complete integration into the global economy.

**Endowment fund:** A fund that spends only income from its capital which is invested as a long-term permanent asset.

**Environmental fund:** Environmental funds (EFs) provide long-term financing for biodiversity conservation and environmental activities. EFs are typically created and managed by majority private organisations, although in some countries governments have played a lead role. EFs have been capitalised through debt-for-nature swaps and debt reduction agreements. Also called **conservation trust funds**.

**Exotic debt:** Debt that is traded infrequently on the secondary market, mostly debt owed by pre-emerging market countries.

**Face value:** The original amount of loans owed under a loan or other credit agreement, prior to debt rescheduling or reduction. Also referred to as the **nominal value** of debt.

**Heavily Indebted Poor Countries (HIPC) Initiative:** Launched in 1996, the HIPC initiative is an agreement by the international community to help poor countries with good policy performance to escape from unsustainable debt burdens by providing comprehensive debt relief. The enhanced HIPC framework, agreed in 1999, lowered the qualifying criteria, speeded up the delivery process and created an explicit link to poverty reduction. About 36 countries, mostly in sub-Saharan Africa, are HIPC-eligible.

**London Club creditors:** Under so-called London Club procedures for restructuring commercial bank debt, a Bank Advisory Committee representing the major creditors is set up, usually chaired by the largest creditor. The committee reaches an agreement in principle with the debtor country, which then must be approved and subsequently signed by the participating creditors.

**Monitoring and Evaluation:** Monitoring is the systematic collection and analysis of information to measure the progress of a project or programme towards expected results. Evaluations are conducted on a periodic basis to assess the progress made towards achievement of results and the lessons learned from experience.

**Net present value (NPV):** The NPV of debt is the sum of all future debt service obligations (interest and principal) on outstanding debt, discounted at the market interest rate.

**Non-Paris Club creditors:** Debt owed to bilateral creditors that are not members of the Paris Club of creditors.

**Paris Club:** The Paris Club is an *ad hoc* group of official bilateral creditors that meets periodically to negotiate rescheduling agreements with debtor countries. The French Treasury serves as the Secretariat for the Paris Club.

**Paris Club debt swap clause:** A clause that has been included in most Paris Club **agreed minutes** (framework agreements between a debtor and its Paris Club creditors) since 1991. The clause currently allows for conversion on a voluntary basis of 100% of ODA loans and up to the higher of 30% or SDR 40 million for non-concessional loans (on an exceptional basis).

**Purchase price:** The price in percentage terms paid to purchase debt from a creditor. The purchase price is the inverse of the discount from face value.

**Redemption price (rate):** The price in percentage terms at which debt is converted into another asset.

**Round-tripping:** Re-conversion of local currency debt conversion proceeds into hard currency for illegal gain.

**Secondary debt market:** A market for trading discounted developing country debt instruments owed to commercial creditors. Also called the **emerging markets debt market**.

**Sinking fund:** A fund that disburses its entire principal and investment income over a fixed period of time.

**Sovereign debt:** Debt owed by governments or by publicly owned agencies.

**Tail-end:** Unguaranteed portion of export credit debt owed to banks and exporters.

**Three-party debt swap:** Debt conversions involving negotiations between a debtor government, an investor and a creditor.

## ANNEX B – ADDITIONAL RESOURCES

### *Bradynet.com.*

A web site devoted to secondary market debt. Although debt prices are only available by subscription, commentary and articles that give a sense of the market are available free of charge.

Curtiss, Randall. *Bilateral Debt Conversion for the Environment, Peru: an Evolving Case Study*. Washington, DC: 1996.

Describes Peru's experience in negotiating bilateral debt reduction programmes. Available from The Nature Conservancy, 4245 N. Fairfax Drive, Suite 100, Arlington, VA 22203-1606, USA, tel: (1) 703-841-4864, fax: (1) 703-841-4880, e-mail: rcurtis@tnc.org.

Debar, Johan and Paneels, Kris. Administration for Development Cooperation, Belgium. *L'Endettement des pays en développement et le programme belge de remise de dette*. Brussels: March 1995.

Description of Belgium's debt-for-aid programme.

Debt Advisory International. *Prospects for Reduction and Conversion of U.S. Sovereign Claims on Developing Countries to Support Overseas Sustainable Development Activities*. Washington, DC: 1997.

Prepared for the Wallace Global Fund. Available from DAI, 1747 Pennsylvania Avenue, NW, Suite 450, Washington, DC 20006, USA, tel: (1) 202-463-2188, fax: (1) 202-463-7285, e-mail: dai@debtadvisory.com.

Emerging Markets Traders Association (EMTA)

63 Wall Street, 20th Floor, New York, NY 10005, tel: (1) 212-908-5000, fax: (1) 212-908-5039, web site: emta.org. EMTA's web site has extensive background information on the secondary market and emerging markets debt.

Global Environment Facility (GEF). *Evaluation of Experience with Conservation Trust Funds*. Washington, DC: 1999.

Provides information on best practices for conservation trust funds. Information on conservation trust funds is available in English, French and Spanish on the GEF web site (<http://www.gefweb.org/html/publications.html>).

Interagency Planning Group on Environmental Funds (IPG). *The IPG Handbook on Environmental Funds*. New York, NY: 2000.

A resource book for the design and operation of environmental funds. Available at <http://www.ctf.homepage.com>, a web site under construction that provides information about conservation trust funds (environmental funds). To order, contact Pact Publications, 777 United Nations Plaza, 6th Floor, New York, NY 10017, tel: (1) 212-697-6222, fax: (1) 212-692-9748, web site: <http://www.pactpub.com>.

International Law Institute. *International Borrowing Negotiating and Structuring International Debt Transactions*. Washington, DC: 1994.

Chapter on *Sovereign Debt Exchanges* summarises the legal aspects of three-party debt swaps involving commercial debt.

Kaiser, Jürgen and Lambert, Alain. *Debt Swaps for Sustainable Development: A Practical Guide for NGOs*. Gland, Switzerland and Cambridge, UK: 1996.

A comprehensive guide to debt-for-development swaps from the NGO perspective. Order from IUCN Publications Services Unit, 219c, Huntingdon Road, Cambridge, CB3 0DL, United Kingdom, tel: (44) 1223 277894, fax: (44) 1223 277175, e-mail: books@iucn.org (US\$10, 70 pages, ISBN: 2-8317-0362-X, Order No. B251). Also visit IUCN's web site (<http://www.economics.iucn.org>) for information on conservation finance.

Organisation for Economic Co-operation and Development (OECD). *Swapping Debt for the Environment: the Polish EcoFund*. Paris: 1998.

Evaluation of the Polish EcoFund. Contact OECD Environment Directorate, Environmental Action Programme Task Force, tel: (33) 1 45 24 93 00, fax: (33) 1 45 24 78 76, e-mail: env.contact@oecd.org.

Rosen, Sydney, Simon, Jonathon, Thea, Donald and Zeitz, Paul. *Exchanging Debt for Health in Africa: Lessons from Ten Years of Debt-for-Development Swaps*. Harvard Institute for International Development (HIID), Development Discussion Paper No. 732. Cambridge, MA: November 1999.

Available from HIID web site (<http://www.hiid.harvard.edu/pub/ddps/ddps.html>). Evaluates experience with debt-for-development swaps and makes the case for debt-for-health swaps.

Sung, Woonki and Troia, Rosaria. *Developments in Debt Conversion Programs and Activities*. World Bank Technical Paper Number 170. Washington, DC: 1992.

Summarises debt-equity programmes, mostly in Latin America.

Swiss Coalition of Development Organizations. *From Debt to Development: The Swiss Debt Reduction Facility*. Berne, Switzerland: August 1998.

Describes the Swiss Debt Reduction Facility, a bilateral debt reduction programme. Available on the SCDO web site (<http://www.swisscoalition.ch>).

United Nations Conference on Trade and Development (UNCTAD). *Conversion of Official Bilateral Debt: Survey of Regulatory and Budgetary Frameworks*. Geneva, Switzerland: 1994.

Prepared by Owen Stanley Financial. Summarises creditor country bilateral debt conversion programmes.

UNDP Office to Combat Desertification and Drought (UNSO). *Debt-for-Environment Swaps for National Desertification Funds*. New York, NY: December 1998.

Prepared by Melissa Moye. Introductory guide to debt-for-environment swaps. Available in English and French. Request from UNSO, 304 E. 45th Street, New York, NY 10017, USA, tel: (1) 212-906-6497, fax: (1) 212-906-6345, e-mail: unso@undp.org.

United Nations Department of Economic and Social Development. *Debt-Equity Swaps and Development*. New York, NY: 1993.

Analyses the impact of debt-equity swaps on development.

US Treasury Department. *Enterprise for the Americas Initiative: Report to Congress*.

Periodic annual reports on the operation of the EAI available from the US Treasury Department's Office of International Debt Policy.

World Bank. *Global Development Finance, Analysis and Summary Tables*. Vol. 1. Washington, DC. 2000 edition contains statistics on bilateral debt conversion. 1998 edition contains the latest chapter on conversion of commercial debt. Also see earlier editions of *Global Development Finance* and the *World Bank Debt Tables* for historical data on debt swaps.

## ANNEX C – SWISS DEBT REDUCTION FACILITY

A public campaign led the Swiss Parliament and Government to create the Swiss Debt Reduction Facility (SDRF) in 1991 on the occasion of the 700th anniversary of the Swiss Confederation. The DRF received an initial endowment of CHF 500 million (about US\$360 million). Its main objective is to alleviate the debt burden of highly indebted countries based on 'creative debt relief'. The State Secretariat for Economic Affairs (SECO, former Federal Office of Foreign Economic Affairs) in Switzerland's Ministry of Economy administers the SDRF, with assistance from the Swiss Agency for Development and Co-operation (SDC) and in consultation with the Swiss Coalition of Development Organisations.

### **Debtor country eligibility**

The following country groups are potential beneficiaries of the SDRF:

- severely indebted low-income countries (SILICS) which have rescheduled their official bilateral debt with the Paris Club;
- programme countries of Swiss Official Development Assistance (ODA) which have also succeeded in rescheduling their debt with the Paris Club; and,
- all other least developed countries that are not in either of the above categories.

About 45 countries are eligible for debt relief under the SDRF. However, the Swiss Government will only enter into debt relief negotiations if the country in question meets the following additional conditions:

- it must be engaged in a medium-term economic reform programme, usually a structural adjustment programme in co-operation with the World Bank and the IMF;
- its conditions of governance (rule of law, democratic principles, public accountability of government, human rights situation) must be acceptable;
- it should have an adequate debt management system which also includes comprehensive and specific steps to reduce external indebtedness to all categories of creditors.

### **Debt relief measures**

The SDRF provides for the funding of both bilateral and multilateral debt relief operations. Four different instruments have been developed since the SDRF's inception in 1991, as follows:

#### ***Official bilateral debt: buy-backs of tail-ends***

This instrument applies only to officially guaranteed export credits, since all ODA loans were cancelled in 1977. In order to forgive or convert export credit debt rescheduled in the Paris Club of creditor countries, the SDRF buys back the un-guaranteed portion of such credits (so-called 'tail-ends') from Swiss exporters and banks. The guaranteed portion of the export credit is held by the Swiss Export Credit Agency (ERG). Following the buy-back of the tail-ends, the ERG transfers its portion to the SDRF. Once these operations have been completed, the SDRF can negotiate forgiveness or conversion of the entire export credit debt, provided that all the conditions are met by the debtor country.

***Commercial bank debt: international buy-backs***

The SDRF provides for the buy-back of commercial un-guaranteed bank debt on a bilateral and a multilateral basis. The main component of this measure is contributions to international debt buy-backs implemented under the IDA Debt Reduction Facility.

***Multilateral debt: clearing of arrears and funding of current obligations***

The initial measure consisted of clearing payment arrears to international financial institutions. Since 1996, the following additional measures were introduced: contributions to the financing of current obligations, to the pre-payment of non-concessional multilateral loans, and, finally, to the HIPC Trust Fund established by the World Bank.

***Complementary measures: balance of payments assistance, technical assistance and capacity building***

The SDRF has provided fresh money in the form of balance of payments assistance, especially to countries that have avoided falling into the debt trap thanks to cautious debt policies. Assistance has also included contributions to the Debt Management and Financial Analysis System (DMFAS) developed by UNCTAD, as well as the HIPC Capacity Building Programme managed by Debt Relief International.

**Debt conversion operations completed**

Two operations to buy back the uninsured portion of officially guaranteed export credits from Swiss suppliers were carried out in 1992. All in all they covered 28 debtor countries, a majority of them in Africa. The prices offered by the Swiss Government were based on secondary market prices for commercial bank debt, plus a small premium. 95% of the exporters involved participated. They sold a total of SFr 350 million worth of tail-end debt at a weighted average price of 20% of face value (purchase price of SFr 71 million). Actual prices ranged from 7% to 51%. Together with the guaranteed portions held by the ERG, the total bilateral claims for these 28 countries amount to approximately SFr 1.3 billion.

Of this amount, roughly SFr 1.1 billion had been treated with 18 countries up to the end of 1997. In 12 countries the Swiss Government negotiated debt conversions, which resulted in the establishment of counterpart funds. In exchange for debt forgiveness, debtor governments agreed to pay a certain percentage of the cancelled debt into a so-called counterpart fund to be used for development projects and programmes that benefit the poor. For these 12 countries, a little over SFr 1 billion was converted to local currency at an average rate of 25% of face value. This generated a total of SFr 267 million in local currencies. Redemption rates ranged from 8% in the case of Zambia to an exceptional 60% in Egypt.

The legal framework for a debt conversion under the SDRF is provided by a bilateral debt relief agreement negotiated between the debtor country and the Swiss Government. In addition to provisions concerning the debt to be converted, the agreement defines the redemption rate, the payment modalities, the sector(s) in which the resources should be invested, the organisational structure of the counterpart fund, and the composition of the body (bodies) responsible for the management of the fund.

The Swiss Government has applied some basic principles relating to debt conversion operations:

- Monetary and budgetary constraints must be considered when negotiating the redemption rate and the payment modalities in order to minimise costs and avoid inflation in the debtor country.
- Switzerland normally asks for up-front payment in cash for the counterpart fund. In cases where budgetary constraints prove to be severe, payments are accepted in several instalments.
- Switzerland prefers the money to be paid into the counterpart fund to be transferred to an interest-bearing account with a private commercial bank in order to ensure independent management of the counterpart fund.
- Ideally, the counterpart fund should be managed by an independent body representing the whole range of organisations in civil society that are active in the priority sector(s) specified in the agreement. The two governments usually also have a seat on the committee(s). An example of the counterpart fund structure established in Peru is attached.
- Within a certain period of time after its constitution, the body or bodies of the fund must work out rules and regulations governing its functions and the allocation of its resources. This includes, among other things, general investment and funding policy guidelines, eligibility criteria, and project selection criteria.
- The resources of the counterpart fund should be used primarily to finance projects and programmes of NGOs and other private organizations.

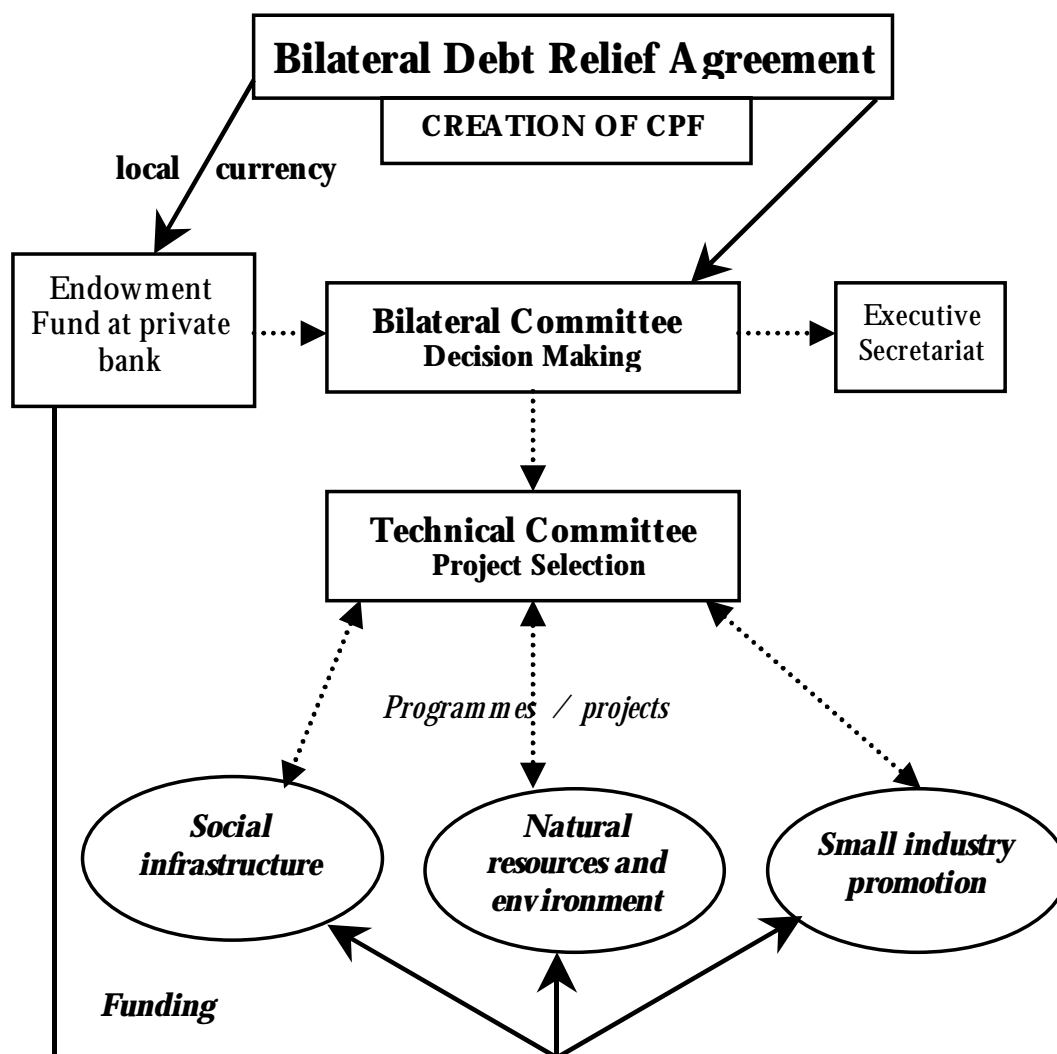
The openness of the counterpart fund structure has led to substantial differences between countries. For example, the fund in Côte d'Ivoire focuses on a single sector (agriculture), whereas the Tanzanian fund is active in five sectors which have not been precisely defined. The role of southern NGOs in designing and implementing counterpart funds has also varied, due to differing political and institutional conditions in the countries concerned, and also to the different approaches used by the Swiss actors involved.

The life spans of the funds, which are all sinking funds, also vary from country to country. Whereas funds in Latin America have a medium-term orientation running from three to about five years, the life span of the funds in Côte d'Ivoire, Egypt and the Philippines is supposed to be at least ten years. The shorter-term orientation is in line with the requirement to transmit the effect of debt relief to the micro-level as quickly and as noticeably as possible. On the other hand, the purpose of a long-term strategy is to establish sustainable financial instruments that benefit grass-roots-oriented and non-governmental organisations.

The Swiss Coalition of Development Organisations has designed a Monitoring and Evaluation (M&E) System focusing on the micro-level impact of 'creative debt relief' implemented through the counterpart funds. Given the small proportion of Swiss debt claims compared with the total external debt of the countries concerned, the impact at the macro level is considered to be negligible. M&E activities focus on the efficiency, effectiveness and sustainability of counterpart funds.

**Source: Summarised from *The Swiss Debt Reduction Facility* by the Swiss Coalition of Development Organisations (August 1998).**

**Figure C.1 Swiss Counterpart Fund Structure, Peru**



Debt volume:	SFr 196.2 mn
Redemption rate:	25%
CPF Volume:	SFr 49 mn
Bilateral Committee:	Ministry of Finance of Peru Swiss Embassy in Lima
Technical Committee	Secretaria Ejecutiva de Cooperación Técnica Internacional de Ministerio de la Presidencia (SECTI) Swiss Development Co-operation (COTESU) Fondo Nacional para Areas naturales protegidas por el Estado (PROFONANPE) Centro de Estudios y Promoción de Desarrollo (DESCO)
Beneficiaries:	50% governmental organisations 50% non-governmental organisations and private sector

*Source : The Swiss Debt Reduction Facility*

## **ANNEX D – USA: ENTERPRISE FOR THE AMERICAS INITIATIVE (EAI) AND TROPICAL FOREST CONSERVATION ACT (TFCA)**

The **Enterprise for the Americas Initiative (EAI)** was created by the United States in 1990 and expanded in 1992 to address official debt burdens in Latin America and Caribbean countries, while promoting environmental protection and child survival. From 1991 to 1993, the US reduced the foreign assistance (USAID) and food assistance (PL-480) debt of Argentina, Bolivia, Chile, Colombia, El Salvador, Jamaica and Uruguay by \$875 million and created local currency trust funds totalling \$154 million. In 1998, Peru benefited from a debt buy-back. The EAI allows for the use of debt reduction, debt buy-back, and debt-for-nature swap mechanisms to reduce debt owed to the US.

The **Tropical Forest Conservation Act (TFCA)** was signed into law in July 1998 to offer the possibility of debt relief in exchange for local currency funding for tropical forest conservation. The TFCA is modelled on the EAI. The TFCA authorises US\$325 million in funding for TFCA, but so far the US Congress has appropriated US\$13 million for FY2000. Implementation of the TFCA is currently underway and Bangladesh will most probably be the first country to benefit.

### **Debt Reduction Mechanisms**

#### ***Debt Reduction***

Debt owed to the US is reduced by a given amount based on the net present value (NPV) of the country's debt to the US budget (expressed in terms of so many cents to the US dollar). The outstanding reduced debt stock is reissued as a new dollar debt payable in 10 to 20 years with a concessional 3% rate of interest. The interest stream is paid into a local currency trust fund. In order to implement an EAI or TFCA debt reduction operation, the US Congress must make appropriations available.

#### ***Debt Buy-back***

The debtor country pays the US Treasury a lump sum dollar payment equivalent to the NPV of part of its outstanding debt and makes a concurrent lump sum payment in local currency into an EAI or TFCA trust fund equal to at least 40% of the buy-back price of the debt. Peru completed an EAI debt buy-back treating over \$177 million in debt with a \$57.1 million buy-back payment and an additional \$23 million local currency equivalent trust fund.

#### ***Debt Swap***

As with a debt buy-back, a third party (such as a conservation organisation) may purchase part of the country's debt from the US Government, paying the NPV of the debt. The debt is then repaid in local currency at an agreed amount to the third party in support of development programmes. Congressional appropriations are not necessary to implement debt buy-back or debt swap agreements.

### **Implementation**

Once a country has successfully negotiated a debt reduction agreement with the United States, it enters into negotiations to create an EAI or TFCA Framework Agreement. The Agreement entails the creation of a Trust Fund to receive interest or lump-sum payments. The US Government requires the Fund to be administered by a local Board of Directors comprising a

majority of local private citizens plus at least one host government member and one US government member. All funds in the trust fund are to be used for grants to local NGOs and community groups in support of the environment and child survival and development (for EAI) or tropical forest conservation (for TFCA).

### **Eligibility Requirements**

In order to qualify for the EAI or TFCA, a country must meet eligibility criteria, as follows:

#### ***Environmental Criteria***

- Presence of at least one tropical forest that is globally outstanding in terms of its biodiversity or that represents a large intact block of forest on a regional, continental, or global scale (only for TFCA)

#### ***Economic Criteria (determined by the US Department of Treasury)***

- Agreement or progress towards an IMF standby arrangement, structural adjustment facility arrangement, or similar mechanism
- If needed, receipt of structural or sectoral adjustment loans from the World Bank/IDA
- Implementation of major investment reforms or demonstrable progress toward an open investment regime
- Agreements with commercial lenders on debt restructuring (if applicable)

#### ***Political Criteria (determined by the US Department of State)***

- Democratically elected government
- Government that does not support terrorism
- Government co-operation on international narcotics control
- Government that does not grossly violate human rights

#### ***Administrative Criteria (set by the Office of Management and Budget)***

- Per capita GNP of \$1,700 or lower (EAI) or per capita income below US\$8,956 as of 1<sup>st</sup> January 1998 (TFCA)
- May not treat an entire debt stock at one time
- Only USAID and PL-480 debt is treated

### **Next Steps**

In order to be considered for the EAI or TFCA, the government of the relevant country needs to express interest to the US Department of the Treasury. Contact should be initiated by the government ministry responsible for debt renegotiation (e.g., Ministry of Finance).

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