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Debt Restructuring Initiatives Paper for the Commonwealth Secretariat[1]

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Abbreviations and Acronyms

AfDB	African Development Bank
BoP	Balance of Payments
CACs	Collective Action Clauses
CBN	Central Bank of Nigeria
CDB	Caribbean Development Bank
CIDA	Canadian International Development Agency
CS-DRMS	Commonwealth Secretariat Debt Recording and Management System
DOD	Disbursed and Outstanding Debt
DSA	Debt Sustainability Analysis
ECCB	Eastern Caribbean Central Bank
EGRP	Economic Governance Reforms Programme
FSF	Financial Support Fund
GDDS	General Data Dissemination System
GDP	Gross Domestic Product
HIPC	Highly Indebted Poor Country
IADB	Inter-American Development Bank
IMF	International Monetary Fund
JDX	Jamaica Debt Exchange
MDRI	Multilateral Debt Relief Initiative
MOF	Ministry of Finance
OECD	Organisation for Economic Cooperation and Development
ODA	Official Development Assistance
PCG	Partial Credit Guarantee
S&P	Standard and Poor's
SIDA	Swedish International Development Agency
SPV	Special Purpose Vehicle
SCMICs	Small Commonwealth Middle-Income Countries
TFCA	Tropical Forest Conservation Act
TFCF	Tropical Forest Conservation Fund
UNDP	United Nations Development Programme
UNICEF	United Nations International Children's Fund
USAID	US Agency for International Development
US	United States
WWF	World Wildlife Fund

Introduction

The purpose of this paper is to review recent debt restructuring initiatives that have taken place in, or are relevant to, small middle-income countries with the objective of identifying:

- Key policy considerations in the decision to pursue a restructuring initiative;
- Key conditions for successful restructuring; and
- Useful insights for the development of innovative policy proposals.

As can be seen from the table below of the 42 countries classified as small middle-income states[2], 27 have debt-to-GDP ratios of over 50%. Of these highly indebted countries, only six (Bhutan, Djibouti, Gabon, Comoros, Guinea Bissau, and São Tomé and Principe) are non-Commonwealth countries.

Table 1: Total Public Debt Levels in Small Middle-Income States including non-Commonwealth (In percent of GDP, as at end-2008)

Low to Medium Debt (0% to 50%)	**High Debt** (Over 50% to 90%)	**Very High Debt** (Over 90%)
Bahamas, The	Belize	Antigua and Barbuda
Bahrain	Bhutan	Barbados
Botswana	Cape Verde	Comoros
Equatorial Guinea	Djibouti	Cyprus
Estonia	Dominica	Gambia, The
Fiji	Gabon	Grenada
Maldives	Lesotho	Guinea Bissau
Micronesia	Malta	Guyana
Namibia	Mauritius	Jamaica
Qatar	Papua New Guinea	São Tomé and Principe
Slovenia	Samoa	Seychelles
Suriname	St. Lucia	Solomon Islands
Swaziland	St. Vincent and the Grenadines	St. Kitts and Nevis
Trinidad and Tobago	Tonga	
Vanuatu		

Source: IMF - Table of Small Country Categories, World Bank

This study seeks, in particular, to address the concerns of small Commonwealth middle-income countries (SCMICs) about their growing debt burden and how to best address these emerging challenges to their overall debt sustainability. Much has been done to address the significant challenges of low-income countries heavily indebted to official bilateral and multilateral

[2] By convention, small states are defined as those having a population of 1.5 million or less. However exceptions have been made for a few countries that have somewhat larger populations but otherwise have characteristics almost identical to small states.

creditors through the Highly Indebted Poor country (HIPC) initiative and more recently through the Multilateral Debt Relief Initiative (MDRI). As a consequence, many of these countries have brought their debts to sustainable levels. In contrast, the debt burden of many small middle-income countries remains high and, with the impact of the global economic downturn, is fast becoming or is already unsustainable. Many of these countries are indebted, not only to official creditors, but also to private creditors. Many also face a large and growing domestic debt burden. This study therefore is concerned with debt restructuring operations implemented by countries outside of the Paris Club to tackle debts other than official bilateral debt. The study in particular focuses on innovations which pertain to the restructuring of official non-Paris Club external debt, private external debt, and domestic debt.

Much of this paper focuses on country experiences with debt restructuring operations. It examines the type of debt restructured and the nature of the debt operation; the challenges encountered in the course of the operation and how they were overcome; and, finally, the outcome of the operation in terms of the portfolio structure and debt dynamics, investor relations and access to finance. However, the paper also explores the use of some financial instruments that have not been widely used by sovereigns but may help to insulate the country from a shock to their overall debt sustainability and help avert a debt crisis. The paper concludes by summarising the lessons learned from the country experiences and identifying key conditions for successful debt restructuring.

The paper is divided into five sections: Section 1 looks at debt exchanges and country experiences with using this mechanism to restructure domestic debt, private external debt and non-Paris Club external debt; Section 2 examines debt conversion schemes implemented in a number of middle-income countries in conjunction with international non-governmental organisations and creditors to reduce the debt burden; Section 3 looks at recent initiatives by multilateral financial institutions to help member countries to restructure their portfolio through various asset liability management operations; Section 4 examines the use of bonds indexed to real variables to help mitigate shocks to a country's debt sustainability; Section 5 concludes with a summary of the main lessons learned and possible considerations for future debt restructuring operations.

SECTION 1 - DEBT EXCHANGES

Debt rescheduling, debt refinancing and even debt forgiveness have been part of the debt restructuring landscape for a number of decades. These traditional methods of restructuring have been widely applied to countries with debt portfolios comprised mainly of loans owed to official and private creditors either externally or domestically. Debt reschedulings involve the deferral of debt service payments falling due to some future data as a means of providing interim cash relief or, effectively, a reduction in debt in present value terms. Debt refinancing involves the exchange of an old loan for a new loan on improved terms. Debt forgiveness involves the extinguishing of all or part of a debt obligation. A less common form of debt restructuring is a debt exchange. This restructuring mechanism has gained prominence in recent years and is a means of restructuring bonded debt.

The increased use of debt exchanges in recent years reflects, among other things, the change in the debt composition of many developing countries. This is especially so in emerging market economies, where over the past decade, borrowing has increasingly occurred through the issuance of securities in the international capital markets rather than through contracting loans. For countries facing payments difficulties and high levels of bonded indebtedness, the options for debt restructuring have been fairly limited. Debt exchanges have been a means by which sovereigns in debt distress can obtain some measure of debt relief.

Restructuring sovereign bonds is inherently difficult. Negotiating a sovereign bond restructuring involves multiple bondholders, often widely dispersed and diversified, making coordination and full consensus on decisions hard to achieve. In addition, up until recently, most bond agreements, particularly those issued under New York law, did not include collective action clauses. These clauses or provisions allow a super majority of bondholders to make decisions regarding the terms of the bond to which all bondholders are bound. Without these provisions, it is extremely difficult to restructure the existing debt. Changing the payment terms so as to restructure the bond and obtain a measure of debt relief requires a unanimous vote of all bondholders. Debt exchanges help sovereign borrowers avoid this problem. They circumvent the need to get a unanimous vote or agreement by a supermajority of bondholders in order to alter the terms of an existing bond. Instead, they offer an alternative whereby sovereign governments can restructure their bonds by offering a new bond to bondholders, which reflects the restructuring terms, in exchange for the existing “old” bond.

Critical to the success of a debt exchange is obtaining as close to a 100% participation rate in the offer as possible. The higher the participation rate the greater the level of relief under the terms

of the offer. Sovereigns may not always achieve this success rate as the danger of holdout creditors is always present. Not only do holdout creditors continue to enjoy the terms of the existing bonds but they may have more leverage to litigate when an exchange offer is concluded. This arises because the remaining bondholders, hostile to the exchange, are likely to form a majority under the existing instrument and therefore more likely to have the voting power to accelerate and enforce their claims under the existing bond terms.

Achieving a successful debt exchange presents a major challenge to sovereign borrowers. The execution of a debt exchange requires considerable planning. Sovereigns must decide whether they opt for a pre-emptive debt exchange to avoid default or whether they should restructure only after they have defaulted on their obligations. They must decide too whether they should negotiate terms with their bondholders or alternatively unilaterally design a restructuring offer and present them as a given. They also have to consider whether to establish a formal consultative group or merely have informal discussions with key bondholders. Countries have adopted very different approaches in implementing a debt exchange and have met with varying levels of success. Some of these have been small middle income countries, such as Belize, Dominica, Jamaica and the Seychelles. Their cases are interesting both for the diversity of approach and the type of debt that have been involved in a debt exchange. The true measure of success is whether their outcomes were consistent with their objectives and whether they secured the debt relief envisaged under the exchange.

The Case of Belize

Economic Background and Debt Dynamics

Launched in December 2006, Belize's debt exchange was the culmination of a rapid build-up in debt in the early half of the 2000s. Expansionary macroeconomic policies pursued by the authorities over the period 1999-2004 led to serious imbalances in the fiscal and external accounts. By the end of 2004, the fiscal deficit had risen to 14.7% of GDP from 9.7% at end-2000. The deficit on the external current account remained high at 6.4% of GDP at end-2004, a reflection of declining export prices and rising energy prices. With the exchange rate pegged to the US dollar, Belize's official reserves also fell precipitously over the period, amounting to less than one month of imports at the end of 2004.

Belize's widening deficits were financed mainly through external debts raised in the international capital markets. With the ease of access to these markets, as global appetite grew for emerging market debt, and a relatively benign global economic environment characterised by lower market rates, Belize's external debt grew rapidly.

Despite growing levels of debt distress, Belize's access to the international capital markets continued unabated. At the time, little consideration was given to the terms on which these market issues were structured and significant cost and risk was imported into the external debt portfolio. Market access was therefore accompanied by increasingly higher rates to refinance the external debt. The weighted average interest rate on external debt amounted to 10.1% at end-2005 rising to 11.25% at end-2006. Rising debt costs and debt levels were further negatively impacted by a succession of tropical storms and hurricanes over the period 1996-2004. The effect of these weather-related shocks was two-fold. First, the need for emergency assistance for recovery, rehabilitation and reconstruction added to the substantial debt overhang. Second, Belize's economic performance, particularly in the traditional sectors, was adversely affected leading to a marked deceleration in growth. Real GDP growth slowed to 3.4% in 2005 compared to 12.1% in 2000.

At end-2004, external debt amounted to 91% of GDP up from 65.6% at the end of 2000, while overall public and publicly guaranteed debt amounted to 100% of GDP up from 71.6%. At 61%, external debt owed to private creditors accounted for the largest share of the total external portfolio. Debt owed to official multilateral creditors amounted for 21% of the external debt while debt to official bilateral creditors amounted to a further 18%.

Measured against exports of goods and services, at 43.6%, and government recurrent revenues, at 106%, Belize's debt service burden was clearly unsustainable. Belize, in 2004, had the unfortunate distinction of being ranked among the twenty most heavily indebted middle-income countries in the world.

Table 2: Belize- Debt Dynamics Pre-Debt Exchange

	2000	2001	2002	2003	2004
	(in percentage of GDP)				
Total Public Debt	84.1	89.6	103.1	102.3	100.1
External Debt	75.6	86.4	97.3	92.3	91.1
Domestic Debt	8.5	3.2	5.7	10.0	9.0
	(in percent)				
Public Debt Service to Government Current Revenues	..	..	..	..	106.0

Source: IMF

The Belizean authorities made a concerted effort to address the worsening economic imbalances through tightened fiscal policies. However these efforts were not sufficient to relieve the debt burden and restore overall sustainability. The decision to undertake a restructuring of the external debt through a comprehensive debt exchange came against the backdrop of high fiscal and external current account deficits and burgeoning debt and debt service burden.

Implementation of the Exchange Operation

In embarking of a comprehensive debt exchange, the authorities decided to adopt a "cooperative" approach, guided by the then recently ratified 'Principles for Stable Capital Flows and Fair Debt Restructuring for Emerging Markets' - a code of conduct intended to guide and structure cooperative actions of sovereign debtors and their private creditors during periods of financial distress. Accordingly the authorities' actions were guided by the following:

1. *Transparency and a timely flow of information*. So as to ensure a fully transparent debt exchange process, the Belizean authorities developed a communication programme to present affected creditors with clear and consistent information in all aspects of the exchange. This effort was significant was prior to the exchange offer there was no formal investor relations programme by the Belizean authorities. Over the four month period from the announcement of the debt exchange to the launch over a dozen press releases regarding the exchange were circulated to Belize's creditors and posted on the Central Bank of Belize's website. This website was used specifically to publish economic and financial data and post debt-related announcements for the benefit of Belize's external creditors. The authorities also hired an information agent, DF King and Company, as information agent to provide details on the actual terms of the exchange.
2. *Close creditor dialogue and cooperation*. The Belizean authorities invited its affected creditors to form a single committee, the Creditor Committee, with whom official negotiations would be conducted. The authorities specified that the committee had to represent "not less than 51% of the affected debt stock"[3] and, in addition, had to be able to "make decisions (including a decision concerning the acceptability of restructuring terms) with the consent of members of the Committee holding not more than 75% of the total amount held by all committee members." The authorities also gave a specific undertaking to:
    a. Provide the Creditor Committee with all economic and financial data made to the IMF;
    b. Ask the IMF staff familiar with the Belize situation to discuss the IMF's views with the Committee;
    c. Ask their financial advisors to share with the Committee the financial analysis prepared by those advisers; and finally,
    d. Be available to discuss the restructuring scenarios, submitted two weeks prior, over a pre-defined two-day weekend discussion period. Notably, the discussion period

[3] See Press Release to External Creditors dated August 2, 2006 by the Government of Belize

was scheduled over a weekend period specifically when trading markets were closed.

3. *Good faith actions*. Good faith principles encourage the sovereign debtor to engage in actions designed to establish conditions for renewed market access on a timely basis, viable macroeconomic growth, and balance of payments sustainability over the medium term. Such actions would include resuming partial debt service as early as feasible and full payments as conditions allow. In this regard the Belizean authorities undertook to use its "best efforts' to remain current on debt service payments on the affected debt until at least the end of formal discussions with the Creditor Committee on the terms of the exchange offer. The authorities also sought the assistance of the International Monetary Fund and the Inter-American Development Bank in the design of a macroeconomic adjustment programme, in the absence of a formal arrangement with the Fund.

4. *Fair treatment of creditors*. A major consideration in the debt exchange process was according fair treatment to all classes of external creditors. In addition to inviting private creditors to participate in the debt exchange, The Belizean authorities also engaged its official multilateral and bilateral creditors. A critical component of the debt exchange was the receipt of substantial concessional financing from the regional development banks, the Inter-American Development Bank and the Caribbean Development Bank, as well as from official bilateral creditors, particularly Taiwan and Venezuela, in support of the debt restructuring effort.

The Exchange

The Belizean authorities launched their offer on 18 December 2006 to exchange US$144.2 million of debt held by external private creditors for new bonds. The closing date of the offer was 15 February 2007. The private debts affected amounted to roughly 50% of GDP. The authorities offered a single bond in the exchange, with the following financial terms:

- A final maturity of 2029 on the new bond, leading to an extension of Belize's external debt maturity profile by some 14 years;
- Equal semi-annual principal amortizations commencing in 2019;
- A step-up coupon structure with annual interest payments set at 4.25% for the first three year after issuance of the new bond, followed by 6.00% for years four and five, then rising to 8.5% thereafter through to maturity; and
- A cash payment at the closing of the transaction equal to the unpaid interest on tendered claims accruing up to the closing date.

Collective action clauses were also included in the new bond thereby allowing a full restructuring of these bonds to proceed once a critical mass of creditors accepted any proposed restructuring terms.

Box 1: Belize – Chronology of Events in Exchange offer	
July 2006	Appointment of Financial Advisors, Houlihan Lokey, Howard & Zukin
August 2, 2006	Announcement of debt restructuring
August 2, 2006	Invitation to form a creditor committee
December 12,2006	Statement by IMF indicating support of exchange
December 18, 2006	Launch of Offer
December 21, 2006	Announcement of Creditor Support
January 26, 2007	Original closing date of offer
February 5, 2007	Announcement of Amendment of Old Notes
February 15, 2007	Revised closing date of exchange offer

Source: Government of Belize

Outcome of the Exchange

Belize's debt exchange achieved the following:

- *Debt Reduction*. The exchange achieved a 21% reduction in Belize's debt in net present value terms. Interest costs dropped to 5.5% of GDP in 2007 from 7.7% in 2006 and overall savings were estimated at US$301 million over five years from the date of the exchange. There was no reduction in the debt in nominal terms.
- *Improved credit rating.* Belize enjoyed an immediate improvement in its credit rating from international ratings agencies. Standard and Poor's raised Belize's credit ratings to B on both its long term and short-term debt from CCC- immediately before the exchange. A stable outlook was also affirmed. Moody's subsequently followed with an upgrade of Belize's sovereign debt to B3.
- *Improved pricing of new bond.* The price of the new bond strengthened substantially following the exchange and Belize also experience a slight reduction in spreads.

Factors contributing to the Outcome

The Belize exchange offer benefited from a number of strategic steps and policy actions:

- *Cooperative Approach*. The establishment of a Creditor Committee made a significant contribution to success of the exchange. The close dialogue between the Belizean authorities and its creditor representatives led to the substantive involvement of the creditors in the structuring of the exchange terms and ultimately to their increased acceptance of the exchange offer before the actual launching.

Notably, significant delays arose in forming the quorum of creditors in the committee given the wide array of affected external debt instruments and the variety of small, dispersed creditors affected by the exchange. As a consequence the timetable over which the exchange was to proceed was significantly lengthened. The exchange was launched almost two months later than originally scheduled.

- *Prior Creditor Support*. Just prior to the launch of the exchange offer, Belize's Creditor Committee announced its unanimous decision to participate in Belize's exchange offer. The creditors mainly from Jamaica and Trinidad and Tobago included: AIC Finance, British American Insurance Company, Caribbean Money Market Brokers, First Global Financial Services, Guardian Asset Management, National Commercial Bank, RBTT Bank, Republic Bank, Sagicor Limited and Trinidad and Tobago Unit Trust Corporation.
- *IMF Support Letter*. A letter of support by the International Monetary Fund endorsing Belize's economic reform efforts and backing the debt exchange offer provided significant leverage to the exchange. The IMF's letter emphasised that "High participation by private creditors in the exchange offer... would help support orderly macroeconomic adjustment, restore fiscal and external sustainability and establish the conditions for strong economic growth". (IMF 2006).
- *Appointment of Financial Advisors.* Belize also benefited from hiring financial advisors, Houlihan Lokey, with extensive expertise in financial restructuring.
- *Transparency of Exchange Process.* The intensive dialogue with creditors and the provision of extensive economic and financial information contributed significantly to the success of the exchange. The Belizean authorities used a variety of channels to communicate with creditors including a dedicated webpage on the Central Bank website where financial data and other information relevant to the exchange was posted.
- *Collective Action Clause in Existing Bonds*. Belize was the first country in over 70 years to use collective action clauses to amend the payment terms of a sovereign bond governed by New York law. Originally, the affected bond received an 87.3% participation rate under the terms of the new offer. The activation of the collective action clauses triggered an 'exit consent clause' which allowed a supermajority (75%) of the original bond holders to apply the restructuring terms to the old bond upon accepting the new offer. This allowed the percentage of total eligible claims restructured to rise from 97% to 98%.
- *High Participation Rate.* Overall, the exchange benefited from a high participation rate of affected holders of the debt. Preserving the principal value of the bond in the exchange offer was identified as the principal factor in the high participation rate.

- *Extension of the Closing Date.* The Belizean authorities extended the closing date of the offer to encourage late participants in the exchange.

Post-Debt Exchange Developments

Belize's public debt-to-GDP has declined significantly since the 2006 debt exchange. Compared to 98.4% at the end of 2005 just prior to the debt exchange, Belize's public debt-to-GDP has declined at an average of 6 percentage points annually to an estimated 75.6% at the end of 2009. Belize's debt service burden has also eased considerably. Over the period 2005 to 2009, debt service as a share of government recurrent revenue has fallen substantially from 90.7% to an estimated 24.6% in 2009. As a share of exports, debt service has fallen from 36.6% to 12.0% over the similar period. The debt exchange, in addition to more prudent fiscal management, has been the main contributor to Belize's reduced debt service burden. Belize's credit ratings were recently reaffirmed at "B" for both its long term and short-term debt by Standard and Poor's a position maintained since 2007 while Moody's upgraded Belize's credit ratings in early 2009.

Belize still remains very vulnerable to external shocks and its debt levels though reduced are still at high levels. However, in the IMF's most recent debt sustainability analysis, Belize's debt is projected to further decline to 69% by the end of 2014 if the authorities maintain a restrained fiscal stance. While the debt exchange did not reduce the debt outstanding, it was nonetheless an effective means of providing debt relief. Belize's debt dynamics have improved post the debt-exchange.

The Case of Dominica

Debt Dynamics

Dominica's debt exchange came in the aftermath of prolonged economic decline and a sharp deterioration in the government's fiscal accounts over the period 1998-2002. Declines in banana production and in tourism had led to economic stagnation and a 4.5% decline in real output at the end of 2002. At the same time Dominica's public finances deteriorated significantly as the government pressed ahead with sharp increases in capital expenditures although there was no commensurate increase in revenues. Over a four year period ending in the 2001 financial year, the overall public sector deficit had quadrupled to 12.5% of GDP while the central government deficit had risen to 10.5% of GDP.

The authorities resorted to heavy external borrowing and substantial arrears accumulation, both domestic and external, to finance the widening budget gap. Reflecting the government's

reliance on borrowing, Dominica's public and publicly guaranteed debt grew from 75% at the end of 2000 to 114% at the end of 2003. External debt as a share of GDP rose from 65% to 79% while external debt service payments rose to about 9% of exports of goods and services.

External debt dominated Dominica's public debt structure and accounted for 67% of the total portfolio at the end of 2003. Debts to multilateral creditors, the largest being the Caribbean Development Bank (CDB), comprised a 64% share of the debt, with a further 3% owed to official bilateral creditors. Debts owed to external private creditors were about 13% of the total external debt.

While domestic debt was the smaller share of the overall public debt accounting for just over 23% at the end of 2003, a significant build up of arrears had emerged. The Dominica Social Security was the most affected entity. The authorities determined that difficulties in clearing both these domestic arrears as well as the sizeable domestic debt arrears left them no option but restructure their debt ahead of a likely default.

Table 2: Dominica - Debt Dynamics Pre-Debt Exchange

	2000	2001	2002	2003	2004
	(in percentage of GDP)				
Total Public Debt	87.4	95.4	121.9	122.0	117.8
External Debt	59.1	71.0	82.4	87.4	92.2
Domestic Debt	28.2	24.4	39.4	34.6	25.7
	(in percent)				
External Debt to Exports of Goods and Services	100.8	140.8	163.2	175.6	

Source: IMF 2004

Implementation of the Exchange

The Dominican authorities hired financial advisors as a first step towards evolving a comprehensive debt strategy. The authorities, in conjunction with their advisors, then sought to craft an approach which would substantively meet two objectives, namely:

- Restoring the long-term sustainability of the public debt; and
- Achieving a high participation rate in any restructuring exercise that they executed.

The authorities determined that a cooperative approach with their creditors, underpinned by transparency, creditor consultations, and inter-creditor equity, would best allow them to achieve their objectives. Consistent with this approach, the authorities pursued debt restructuring negotiations with all three main classes of creditors: multilateral creditors – specifically the Caribbean Development Bank, official bilateral creditors, and private creditors –

both domestic and external. Debts to all these creditors became eligible for restructuring with the exception of multilateral preferred creditors, namely the IMF and the World Bank, short-term domestic Treasury bills, and the operating overdraft facility held with the Eastern Caribbean Central Bank (ECCB). The restructuring operation contemplated for each class of creditor was as follows:

- *Multilateral creditors*. A one-on-one bilateral negotiation with the Caribbean Development Bank;
- *Official bilateral creditors*. Creditors were invited to participate either in a debt exchange offer launched by the authorities or in a debt restructuring exercise through the Paris Club.
- *Private creditors (domestic and external)*. Creditors were invited to participate in the debt exchange offer that involved a net present value reduction in the outstanding eligible debt.

Except for the debt exchange the authorities made significant progress on their restructuring programme. In terms of multilateral debt, the Caribbean Development Bank, the sole multilateral financial institution with debt eligible for restructuring, agreed to restructure the majority of their claims to Dominica. In lieu of a nominal debt reduction, the CDB approved a considerable reduction in debt in present value terms. The CDB achieved this by introducing long grace periods, significantly extending the maturities, and by lowering interest rates. Significantly, the CDB continued to lend to Dominica in spite of the restructuring exercise.

The authorities were not successful in negotiating a restructuring agreement with official bilateral creditors within the framework of a Paris Club agreement. The Paris Club determined that negotiations should take pace bilaterally with each affected creditor as only two creditors out of the pool, the United Kingdome and France, were Paris Club members. The authorities redirected their efforts to negotiate bilaterally with their donors, seeking a 50% net present value reduction in their official bilateral debt. The UK, France and other non-Paris Club members agreed to restructure their claims.

Box 2: Dominica – Chronology of Events in Exchange offer

April 6, 2004	Announcement of debt restructuring
April 30, 2004	Original closing date of offer
June 11, 2004	Revised closing date of offer
July 15, 2004	Caribbean Development Bank restructures its claims
September 2004	Closing date for late participation

The Exchange

In April 2004, the Dominican authorities launched an offer to exchange US$144.2 million of debt held by external and domestic private creditors for new bonds. The private debts affected

amounted to 54% of the total eligible debt and 56.5% of GDP. The authorities offered three new bonds in the exchange, namely:

- *A Short Bond.* A short bond with a bullet maturity of 10 years and issued with a 30% discount on the principal amount. The terms of the exchange stipulated that the short bond was only available to creditors with eligible debts maturing within two years of the exchange offer.
- *An Intermediate Bond.* An intermediate bond with a bullet maturity of 20 years and issued with a 20% discount on the principal amount.
- *A Long Bond.* A long bond issued at par with a bullet maturity of 30 years.

Al three bonds were issued in local currency, the Eastern Caribbean dollar, and carried an interest rate of 3.5%.

Two additional features were included in the new bond issue:

- *Collective Action Clauses*. These clauses were included in the new bonds thereby allowing a full restructuring of these bonds to proceed once a critical mass of creditors accepted any proposed restructuring terms.
- *A Mandatory Debt Management Clause*. This clause allowed the authorities to buyback the new bond if their financial situation improved.

Box 3: Dominica - Summary Terms of Commercial Debt Exchange	
Opening Date:	▪ April 6, 2004
Expiration Date:	▪ April 30, 2004
Settlement Date:	▪ May 19, 2004
Eligible Debt:	▪ All external and domestic commercial debts, except Treasury Bills and the operating overdraft
Transaction Type	▪ Debt exchange
New Bonds:	▪ New Short bond issued at 30% of principal value, and maturing 2014, with 20% of face value redeemed each year beginning in year 6. ▪ New Intermediate bond issued at 20% of principal value and maturing 2014, with 8% of the face value redeemed each year in years 7 through 17, and 4% of the face value redeemed each year in years 18 and 19. ▪ New Long bond issued at 100% of principal value and maturing 2024, with 8% of the face value redeemed each year in years 15.5 through 26, and 4% of the face value redeemed each year in years 27 through 29.
Pricing:	▪ New Short, Intermediate, and Long bonds all priced at fixed rate of 3.5%
Allocation Rules:	▪ Citibank/RBTT bonds exchanges to either new intermediate or long bonds ▪ Other short-term commercial claims exchange for either new short,

	intermediate or long bonds ▪ Other medium-term commercial claims exchange for either new intermediate or long bonds
Target participation:	▪ All private creditors
Key Features	▪ New bonds governed by law of Trinidad and Tobago ▪ Accrued interest on old bonds paid in cash at original settlement date

The Result

Dominica's debt exchange was not entirely successful. Three months after the formal closing of the exchange offer a participation rate of around 70% had been achieved. Participation was higher among Dominica's domestic private creditors, the largest of whom was a public sector entity, than its external private creditors. There were a significant number of holdout creditors, some of whom decided to litigate to secure payments on their bonds on the original terms. The authorities, however, determined that they would not service the claims on non-participating creditor on the original terms but instead on the terms of the exchange offer. However, as a "good faith" gesture, these amounts were paid into an escrow on behalf of the non-participating creditors to be disbursed to them on acceptance of the restructuring terms. Notwithstanding the difficulties involved in restructuring external private claims, the authorities achieved a debt reduction of 50% in net present value terms.

Factors Contributing to the Outcome

A number of factors contributed both positively and negatively to the performance of Dominica's exchange offer. They highlighted the important considerations necessary when undertaking a comprehensive debt restructuring, especially a debt exchange. Among the success factors in the exchange were:

- *Extensive Creditor Consultations.* The authorities along with their financial advisors went on a roadshow to meet with various creditors and outline their need for debt restructuring. In their presentations, the authorities not only argued the case for inter-creditor equity but outlined the desired net present sought under the exchange.
- *Inter-Creditor equity approach.* The authorities' inter-creditor equity approach achieved a wholesale restructuring of their entire portfolio, both domestic and external. Substantial support was extended by the multilateral institutions such as the IMF, who provided financing under a Stand-By Arrangement, and the CDB, who restructured their claims by reducing interest rates and lengthening maturities. Bilateral creditors such as Barbados, the UK and Venezuela also agreed to a 50% reduction of their claims in net present value terms.

- *Good faith actions.* The authorities undertook several good faith actions to encourage participation. In addition to approaching creditors pre-emptively, the authorities continued to fully service their obligations during the process of the exchange. The authorities also paid creditors in cash all interest accrued under the old bond provided they participated by the closing date. Late participants were paid with the new short bond under the exchange. As a final step, the authorities opened an escrow account at the Eastern Caribbean Central Bank (ECCB) into which they made periodic payments to non-participating creditors on terms consistent with the exchange offer. These payments were available to creditors on acceptance of the exchange offer.

However, a number of factors negatively affected the execution of the exchange.

- *Inadequate creditor information*. A significant factor in the slow participation rate was that the authorities had no contact details or incorrect contact details for many of the small eligible bondholders. This made it difficult to notify eligible creditors of the exchange offer and invite their participation.
- *Manual debt system.* A significant challenge to the authorities was to determine the size and the structure of the debt. While a comprehensive computer software package, the Commonwealth Secretariat Debt Recording and Management System (CS-DRMS), was used to record information on external debt, only a manual system was used to record domestic debt. Difficulties were encountered in accurately tabulating the total amount of domestic and external debt outstanding and also in calculating the exact level of arrears. A reconciliation exercise also revealed the incorrect recording of claims and the presence of external arrears. Although this did not prevent the execution of the debt exchange the inaccurate presentation of information did lead to breaches under the terms of the authorities programme with the IMF.
- *Lack of internal capacity in debt management.* The authorities indicate that a lack of internal capacity in debt management made the restructuring process challenging even with the services of experienced team of legal and financial advisors.
- *Absence of collective action clauses.* The absence of collective action clauses made it difficult to obtain full participation in the exchange offer. Collective action clauses provide for a full restructuring to proceed if a super-majority of the existing bondholders agree to the terms of a restructuring agreement. They also allow the terms of the original bond to be restructured along the terms of the new bond if agreed to by a super-majority of bondholder upon exit.

- *Inclusion of complex instruments.* The authorities encountered significant difficulties in restructuring some of their external claims. Derivatives created with two original bond issues, in addition to legal disputes surrounding the validity of some of the claims, made it difficult for the authorities to proceed with the exchange and gain full participation.[4]
- *Hostile creditors.* Some external private creditors were hostile to the debt exchange and did not participate in the offer. Among these, one creditor took court action against the Dominican authorities to recover payments under the terms of the original claim.

Post-Debt Exchange Developments

Dominica's debt dynamics improved markedly following the 2004 debt exchange. Debt-to-GDP levels fell from 122% at the end of 2003 to 78% at the end of 2008. The debt exchange along with tight fiscal management underpinned the overall improvement in Dominica's debt sustainability. However, problems persist with holdout bondholders and Dominica's debt exchange remains incomplete. The Dominican authorities continued to negotiate with holdout creditors with the aim of having them agree to the debt exchange. The authorities continue to make debt service payments into an escrow account on the terms of the 2004 exchange arrangement.

The Case of Jamaica

Jamaica launched a domestic debt exchange on 14 January 2010. The objective was to comprehensively restructure the domestic portfolio by extending maturities and reducing the interest payment burden of the debt.

The Background

Jamaica's domestic debt exchange came against the background of economic decline and a high and unsustainable debt burden. Jamaica, given its openness, has been very vulnerable to global economic and financial shocks. Mainly dependent on export earnings from tourism and bauxite, Jamaica has averaged a low growth rate of 2.3% over the past two decades. Since 2008, the economy has been in decline with the economy contracting at an annual average rate of -2.4% over the past two years. Public debt amounted to 135% of GDP at the end of 2009 with domestic debt accounting for more than half the share at 55%. Jamaica's domestic debt increased substantially over the course of the decade largely as a result of the Jamaican government's intervention in the country's financial sector collapse in the late 1990s and the assumption of financial sector obligations on the central government's budget in 2001. Domestic debt, which

[4] For a further elaboration of the debts Dominica had in dispute see IMF Country Report No. 04/286.

was at a low of 25.9% of GDP at the end of 1995, jumped to 70.5% of GDP at the end of 2001 and rose further to 75% of GDP at the end of 2009.

Medium to long-term debt securities comprised almost all Jamaica's domestic debt portfolio. Domestic loans and Treasury bills together accounted for just over 1% of the total domestic debt in 2009. Domestic debt securities, while issued mainly in domestic currency, also had a sizeable foreign currency component. Some 15% of total domestic debt was either denominated in or indexed to the US dollar.

Table 3: Jamaica - Debt Dynamics Pre-Debt Exchange

	2005	2006	2007	2008	2009
	(in percentage of GDP)				
Total Public Debt	119.0	117.5	113.3	109.9	135.0
External Debt	50.0	49.4	48.6	48.7	
Domestic Debt	69.1	68.1	62.7	58.1	
	(in percent)				
Public Debt Service to Government Revenues					100.1

Source: Ministry of Finance, Jamaica

By all indicators Jamaica's domestic debt was unsustainable. Domestic debt service consumed over 99% of central government tax revenues and 60% of the total government budget. Domestic interest payments accounted for 76% of total annual interest payments in 2009. That much of Jamaica's debt was short-dated exacerbated the fiscal burden of the debt. The authorities were faced with the prospect of a significant portion of the portfolio, 27% of GDP, maturing within two years. With high nominal interest rates upwards of 15%, Jamaica's domestic interest burden was significant.

Objectives of the exchange

With the exchange offer, the Jamaican authorities sought to meet four main objectives.

- *Reduce the interest burden of the debt and extend maturities.* The terms of the exchange offer were structured to accomplish this by reducing the coupon rates by between [200-400 basis points] and extending the maturity dates of the new bonds in a range of 2 to 20 years.
- *Alter the composition of its portfolio to reduce its exposure to interest rate risk.* A large share of the domestic debt portfolio comprised variable rate securities benchmarked to the Treasury bill rate. The objective was to increase the holdings of fixed rate debt by exchanging some variable rate debt for fixed rate date and exchanging fixed rate instruments only for new fixed rate instruments.
- *Ensure that the stability of the financial sector was maintained.* A major consideration in the adjustment to the coupon rates and the life of the bonds was the impact of these changes on

the domestic financial sector. Commercial banks and other financial institutions had significant holdings of government securities on their balance sheets. The authorities were keen to ensure that there was no recurrence of a financial sector meltdown as occurred in the late 1990s. A liquidity support programme, the Financial System Support Fund (FSF), was established by the authorities to be made available to financial institutions fully participating in the exchange with 100% of their old bonds. The FSF allowed for eligible financial institutions entities to borrow up to 100% of the nominal amount of bonds pledged in the exchange. The FSF was funded as part of a multilateral package of financing accompanying the exchange.

- *Achieve a high participation rate in the offer.* The authorities stated that they would not accept offers under the debt exchange unless they received overall participation rate of 90% as well as a nearly 100% of participation of old bonds with two years to maturity and a nearly 100% participation of all fixed rate old bonds. The authorities emphasised that obtaining an earmarked US$2.4 billion in financing from multilateral financial institutions including the IMF, was contingent upon obtaining a substantially" 100% participation rate in the exchange offer. Failure to realise the 100% target would therefore undermine the authorities' economic programme and put the stability of the financial system at risk. Prior to the exchange the authorities also announced that failure to participate could trigger the government pursuing fiscal or other measures to "... prevent 'free-riders' and level the playing field with those investors who participated in the exchange".

Implementation of the Debt Exchange

The Jamaican authorities were aware that restructuring almost the country's entire domestic debt portfolio had significant economic, political and social implications. Given the amount contemplated for restructuring and the financial losses that would negatively impact not only the financial sector but small retail investors, particularly pensioners, the government actions in implementing the exchange were guided by the need to achieve wide acceptance of its

Two major challenges confronted the Jamaican authorities in the execution of the exchange. The first was how to encourage high participation by the large number of small 'retail' investors holding government securities and the second was how to handle the substantial volume of physical bond certificates that would be submitted by bondholders in the exchange. Debt securities under the existing legislation could not be issued in dematerialised form. The new notes were to be issued in the form of registered certificates with the possibility of being reissued in dematerialised form with the future amendment of legislation. The exchange offer was therefore structured to:

1. Simplify the choices for small investors to allow for a high level of retail participation; and
2. Split the responsibility for the certificate submission process to allow mass processing of small retail orders and efficient processing of small number of large and complex institutional orders.

In implementing the exchange, the authorities took the following steps:

1. *Appointment of Financial Advisors.* The authorities appointed the local arm of Citi as their financial advisors in November 2008. The authorities felt it was critical to appoint advisers who had extensive local knowledge of the market and had an excellent track record of executing an exchange transaction. Citi was first appointed to work on a liability management programme with the intent to develop Jamaica's first debt exchange offer. Initially the transaction under consideration was much smaller, focusing only on domestic securities maturing within two years so as to lower refinancing costs. However, a sharp rise in market rates during the strategy development period altered the scope of the exchange offer from addressing the shortest bonds only to restructuring the entire portfolio.
2. *Formation of a communication strategy team.* The authorities formed a communication strategy team comprising the government's information agency, the Jamaica Information Service, the Bank of Jamaica, the Ministry of Finance and the Office of the Prime Minister. The team was mandated to devise a marketing and communication strategy that minimised market uncertainty, managed any negative responses to the exchange, and ensured that all affected bondholders and civil society was fully aware of the transaction.
3. *Extensive Stress Testing of the Financial Sector*. The Bank of Jamaica in collaboration with the IMF conducted extensive stress testing of the financial system to determine the "expected income and fair value losses and other potential 'knock on' effects associated with the exchange."[5] The authorities' objective was to ensure the stability of the overall financial system post-debt exchange and to avoid a reoccurrence of the financial sector collapse experienced in 1996/97.
4. *Broad based market consultation*. The authorities adopted a cooperative approach which involved ongoing and broad-based consultations with the financial sector. The authorities could have triggered the call option embedded in the terms of the domestic securities. However, not only did the authorities have insufficient funds to exercise the call option but no support would have been provided by the IMF if this strategy had been pursued.

[5] From text of "Governor's Remarks – Jamaica Debt Exchange" at the launch of the debt exchange (JDX) on 14 January 2010

5. *Public relations management*. The authorities were very aware of strong negative response by investors to any mention of the term "debt restructuring'. Over the years, the authorities had carefully nurtured a reputation of creditworthiness even amid deep fiscal constraints. An ongoing assurance to the market was that Jamaica's constitution provided for debt being the first charge on the government's budget and that the government had never defaulted o its debt.[6] The sceptre and sound bite of a debt restructuring, synonymous with default, was to be painstakingly avoided to allay fears both locally and internationally about the authorities reneging on its debt commitments. Up until the launch of the exchange, the authorities were careful to refer to the debt exchange as a "liability management exercise" rather than a "debt restructuring" programme.

6. *Implementation of an IMF programme*. Faced with severe fiscal constraints and the need for substantial budgetary support, the authorities decided to resume a borrowing relationship with the IMF after a period of 14 years. The authorities recognised that the success of the debt exchange hinged on bondholders being assured of the government's long-term commitment to economic and structural reform and accountability only though the IMF's stamp of approval. Negotiations for a 27-month US$1.2 billion IMF Stand-by programme were conducted in parallel to the development of the exchange offer.

The Debt Exchange

Against these objectives, Jamaica's domestic debt exchange (JDX) was opened on 18 January 2010. The debt exchange applied to all marketable domestic debt securities, with the exception of Treasury Bills, whether denominated or indexed in domestic or foreign currency. Under the terms of the offer, all marketable securities issued under local law prior to December 31, 2009 and maturing after 16 February were eligible for the exchange. In effect, only very short-dated instruments with an original maturity of less than two months were excluded from the exchange. Some 340 debt securities issued by the government of Jamaica were affected. Eligible investors were restricted to Jamaican residents who were holders of these securities.

Box 3: Jamaica - Summary Terms Debt Exchange	
Expiration Date:	▪ January 26, 2010
Settlement Date:	▪ February 16, 2010
Eligible Bonds:	▪ J$700 billion local law bonds (including fixed rate, variable rate and US dollar denominated or US dollar indexed bonds) ▪ Marketable bonds issued prior to December 31, 2009 and maturing after February 16, 2010

[6] Notably, Jamaica rescheduled its debt repeatedly with the Paris Club and London Club during the 1980s and 1990s.

Transaction Type	▪ Par-to-par exchange ▪ Accrued interest on old bonds paid in cash at settlement date
New Bonds:	▪ Twenty four new benchmark bonds ▪ Fixed bonds are non-call life
Pricing:	▪ New local currency bonds priced in the range of 12-13% ▪ New US dollar bonds priced near 7%
Allocation Rules:	▪ All exchanges from shorter dated bonds to longer dated bonds ▪ Fixed rate old bonds only to fixed rate new bonds ▪ US dollar old bonds only to US dollar new bonds ▪ Variable rate old bonds to variable rate, fixed rate or consumer price indexed new bonds
Target participation:	▪ Bonds maturing within two years and high coupon fixed rate bonds

Source: Debt Management Unit, Ministry of Finance, Jamaica

Under the terms of the exchange, all affected domestic debt securities were to be exchanged for a series of 24 new notes which had a variety of payment terms. These benchmarks notes were grouped into four main categories:

1. *Fixed rate notes, denominated in Jamaican dollars.* These were fixed rate notes with maturities ranging from 2010 to 2040 with coupon rates in the range of 11-13.25%;
2. *Fixed rate notes, denominated in United States dollars.* These were fixed rate US dollar denominated notes, with maturities ranging from 2013 to 2016 and priced near 7%;
3. *Variable rate notes, denominated in Jamaican dollars.* These were variable notes, with maturities ranging from 2011 to 2032; and,
4. *Long-term indexed bonds*. These were medium to long term bonds denominated in Jamaican dollars, and indexed to Jamaica's consumer price index. These bonds matured between 2022 and 2030 and carried coupon rates of between 2.0 and 4.25%.

Existing bonds were to be exchanged at 100% of the principal value with the new bonds.

Box 4: Jamaica – Chronology of Events in Exchange Offer

November 2008	Debt Management Unit begins work with financial advisors to develop exchange offer
February 2009	Local market initiative proposed to Government of Jamaica
March 2009	Broad market consultations begin
December 2009	Final consultation with financial advisors, the IMF, IADB and the World Bank to ensure full integration with the authorities medium term–economic programme
January 10-13, 2010	Final pre-market consultations
January 14, 2010	Statement by IMF indicating support of exchange
January 14, 2010	Launch of Offer

January 18, 2010	Opening date of exchange offer
January 26, 2010	Original closing date of exchange offer
February 3, 2010	Revised closing date of exchange offer
February 16, 2010	Original settlement date of exchange offer
February 17, 2010	Fitch upgrades Jamaica's ratings
February 24, 2010	Revised settlement date of exchange offer

Source; Government of Jamaica, public media releases

Under the terms of the exchange, retail investors holding bond certificates with an individual value of J$5 million (approximately US$45,000) and an aggregate value not exceeding J$25 Million (US$250,000) were given the option - the 'Retail Offer' - of having their old notes exchanged for a single new bond maturing in 2013. Retail investors accepting the offer would then be entitled to receive:

a. A fixed rate Jamaica dollar denominated new bond, maturing in 2013 in exchange for a fixed rate Jamaica dollar denominated old bond;

b. A fixed rate US dollar denominated new bond, maturing in 2013 in exchange for a fixed rate US dollar denominated old bond;

c. A variable rate Jamaica dollar denominated new bond, maturing in 2013 in exchange for a variable rate Jamaica dollar denominated old bond;

The terms specified that both the Bank of Jamaica and the Ministry of Finance would be involved in the collection of physical certificates. The Bank of Jamaica had responsibility for collecting low-volume certificates (10 certificates or less) while the Ministry of Finance collected high-volume certificates. Bondholders submitting more than 10 physical certificates were required to submit all their physical certificates in a single bundle accompanied by a single form indicating the desired distribution of old bonds in exchange for new bonds.

One further provision was included in the exchange offer. This was that the government's acceptance of the offer was conditional upon a participation rate of over 90% of all debt securities, including a nearly 100% participation rate of old securities with less than 2 years remaining to maturity and a nearly 100% of all fixed rate securities. The authorities also announced to eligible bondholders that a successful debt exchange of "substantially" 100% participation was a pre-condition for the Jamaican government gaining approval from the International Monetary Fund for a US$1.2 billion facility under a Standby Agreement and for obtaining access to substantial exceptional financing from other multilateral financial institutions.

The exchange offer stated an opening date of 18 January, a closing date of 25 January and a settlement date of 16 February, 2010.

Outcome of the Debt Exchange

Jamaica achieved significant success in its debt exchange, namely the following:

1. *Debt Service Reduction*. The debt exchange achieved interest savings of J$40 billion (US$449 million) or 3% of GDP in 2010/11. Central government interest payments were estimated to fall sharply from 16.2% of GDP at the end of 2009/10 to 9.7% of GDP by 2013/14. In addition, the volume of debt maturing over the three years immediately following the exchange was reduced by 65%.
2. *Improved Pricing of New Bond*. The average interest rate of the new bonds amounted to 12.25% or some 200-300 basis points below the average rate applicable to the old bonds.
3. *Improved Credit Rating*. Jamaica benefited from an immediate ratings upgrade from the international ratings agencies. Fitch ratings agency upgraded Jamaica's long term foreign and local currency rating to B- and determined Jamaica's rating outlook as stable. Standard and Poor's also upgraded Jamaica, raising Jamaica's ratings out of selective default (SD) and assigning a B- rating on Jamaica's long-term foreign and local currency debt.
4. *High Participation Rate*. A voluntary participation rate of over 99% was achieved in the exchange, ranking the debt swap as one of the most successful exchanges in the world. A near 100% participation rate was achieved among institutional investors, while the rate among retail investors was close to [97%].
5. *Restructured Domestic Debt Portfolio.* The debt exchange significantly altered the composition of the domestic debt portfolio. Not, only was the maturity profile substantially extended and smoothed but the fixed rate share of the domestic debt rose significantly The share of fixed rate debt increased by 7 percentage points to 41% of total domestic debt while the share of floating rate debt fell by 10 percentage points to 44%. Newly introduced consumer price indexed bonds accounted for 3% of total domestic debt while the share of US dollar denominated debt remained unchanged at 12%.
6. *Consolidation of issues.* The Jamaica domestic debt exchange also resulted in less fragmentation of the portfolio as 350 small bonds were converted into 24 benchmark bond issues.

Key Factors in the Outcome of the Exchange

A number of factors contributed to the success of Jamaica's debt exchange including the following:

1. *Broad national consensus.* A major factor contributing to the success of the debt exchange was broad national consensus that present debt levels were unsustainable and that there were few, if any, options outside of a comprehensive debt restructuring if economic recovery and debt reductions was to be achieved. Three factors contributed to the high consensus level:

    a. *High public awareness of the fiscal problem.* Information on the government's fiscal accounts, debt levels and economic performance was widely available to the public through the published data on the Ministry of Finance website and through the media.

    b. *Aggressive sensitization programme*. The authorities in conjunction with their financial advisers consulted not only with the financial sector but with a wide cross section of civil society and political organisations including the main opposition party, the trade unions, various private sector organisations and the media, particularly the media owners. Several interest groups, such as the Private Sector Organisation of Jamaica, the Bankers Association of Jamaica, and the editors of the leading newspapers announced their support for the exchange.

    c. *Nationalism*. The exchange benefited from a high level of patriotism and enlightened self-interest among local investors. There were strong indications that the issue of debt and economic growth was widely considered a 'national problem' which required a 'national response'. Supporting this notion is that prior to the contemplation of the debt exchange, several bankers approached the authorities with specific initiatives for a comprehensive reduction of the public debt. Local investors widely accepted the debt exchange as the loss of private income for a social good. As the editor of a leading newspaper stated, "We have no doubt that what needs to be done will bring with it considerable pain. However, we believe that if the measures are properly implemented and the government displays fiscal discipline, the end result will be worth the pain."[7]

2. *Extensive market consultation*. The authorities consulted extensively with the financial sector over several months up to the launch of the exchange. Market consultations included group meetings as well as several individual meetings with leading banks, securities dealers and pension managers. To add weight to the consultative process, the prime minister, minister of finance, central bank governor and financial secretary held extensive discussions with 'the Big 4' – the leading financial institutions with substantial holdings of government

[7] See Editorial, Jamaica Observer, 13 January 2010, "Support for the Debt Exchange"

securities - to secure their commitment to the exchange. The Debt Management Unit also held technical meetings with treasurers, trading desks and actuaries of major financial institutions. The financial advisors also consulted with the IMF to ensure that the design and execution of the exchange was fully integrated with the pending IMF economic programme. These market consultations were reflected in the final terms of the exchange offer, including:

a. The inclusion of inflation indexed bonds as requested by pensions funds;

b. The inclusion of fixed rate non-callable bonds for asset/liability matching for pension and insurance companies;

c. The substantial interest rate reduction, subject to the authorities committing to an effective economic and structural reform programme.

3. *Commitment to economic and structural reform*. The authorities' commitment to an economic reform programme supported by the IMF and World Bank was integral to the success of the exchange. The linchpin of the economic programme was comprehensive fiscal reform combined with tighter fiscal management, including the targeted reduction of the public sector deficit from an estimated 13% of GDP in 2009/10 to near balance over a four year period. The authorities also undertook to complement the strong macroeconomic adjustment effort with core structural reforms that entrenched fiscal discipline. These reforms included enacting fiscal responsibility legislations to ensure prudent fiscal management; introducing a central treasury management system which was to consolidate treasury management in one agency and establish a Treasury Single account to enhance cash management; and comprehensive reforms in public bodies and public employment.

4. *Precondition to Exceptional Multilateral Support*. Both the authorities and the IMF impressed upon bondholders that access to US$2.4 billion in exceptional support from the multilateral financial institutions, including, the IMF, was conditional on near 100% participation in the debt exchange. The authorities went further in stressing to the financial sector and the broad public that in the absence of multilateral support, economic hardship would be considerably worse and the possibility of debt default greater.

5. *Supporting Framework*. The debt exchange was complemented by a number of other policy actions and initiatives including a US$1.2 billion IMF Stand-by agreement and supplementation multilateral funding from the IADB, CDB and other agencies amounting to an additional US$1.2 billion. Total support from the multilateral institutions amounted to roughly 20% of Jamaica's GDP.

6. *Simplification of the debt exchange for small retail investors*. Providing small retail investors with the option to subscribe to only one new benchmark bond rather than choose among the 24 new bonds greatly simplified their decision process. Retail participation in the new earmarked 2013 bond exceeded [95%].

7. *Closure of the International Capital Markets*. The closure of the international capital markets and a lack of access to concessional funding contributed to the success of the exchange in two ways:

    a. It severely constrained the options available to the authorities and thus provided the impetus to pursue the debt exchange programme and ensure its success.

    b. Limited the impact of the series of downgrades announced by the ratings agencies on being alerted to the debt exchange as financing was already unavailable from the capital markets.

Post-Debt Exchange Developments

The most significant impact of Jamaica's recent 2010 debt exchange has been the marked reduction in debt payments in the government's 2010/2011 budget. Debt service payments as a percentage share of the government's budget will fall from 61% in 2009/2010 to 48% in 2010/2011, the first time in 13 years that the ratio has fallen below 50%. The ratio was 49% in 1997/1998.

While the debt exchange has notably eased Jamaica's interest burden, concerns have been raised by various institutional groups about the effect of the debt exchange on their cash flows. Most notably, in 2010/2011, Jamaica's social security scheme, the National Insurance Fund, is expected to earn US$13.4 million below the projected US$44.8 million in interest from domestic bonds.[8] Immediate worries are that this will affect the ability of the Fund to meet its commitments. The Jamaica debt exchange has also been associated with some of staff cuts at various financial institutions in the months after the exchange. The country's largest bank, National Commercial Bank announced in March 2010 it was cutting 100 members of staff from its payroll to achieve "optimal efficiency. The Bank exchanged US$1 billion in domestic bonds equivalent to 28% of its total assets. Other financial institutions have combined staff cuts with hikes in banking fees to help recover from losses in interest income on government securities. While the debt exchange represents a substantial cost the financial sector indicators are that the financial sector remains viable and that Jamaica's debt fundamentals have improved.

[8] See Caribbean 360.com, March 18, 2010, Jamaica Debt Exchange affects National Insurance Fund

The Case of the Seychelles

Background and Debt Dynamics

The Seychelles debt exchange came against the background of a severe balance of payments and public debt crisis which erupted in 2008. The authorities had pursued a decade of expansionary monetary and fiscal policies as part of their overarching development objective to double per capita income by 2017. However, persistent macroeconomic imbalances coupled with an inflexible exchange rate regime and complex exchange restrictions lead to a steady deterioration in Seychelles export competitiveness. Economic growth declined. From an average real growth rate of 7.5% in 2005-07, Seychelles growth rate fell by more than half to 3.1% in 2008. The economy shrank by 9.5% in 2009.

The global economic downturn exacerbated Seychelles weak economic performance as did the fuel and food price shocks that hit the economy in 2007-08. A growing shortage of foreign exchange prompted the authorities to liberalise the exchange regime and float the domestic currency, the rupee. The currency fell by almost 50% after the float though it regained some of its value in the following year. To sustain budgetary spending, the government borrowed in the international capital markets. Between 2006 and 2007, the authorities also issued three bonds: a US$200 million Eurobond maturing in 2011, a privately placed amortising note for €54.7 million; and a US$30 million supplement to the Eurobond.

The programme of reforms was implemented by the authorities in 2007. However these efforts were insufficient to stem the economy's downward spiral. During 2007-08, inflation surged, accelerating to 32% from 5.2% a year earlier, the current account widened and a substantial build-up of external payment arrears occurred. By 2008, the country's reserves were virtually exhausted and Seychelles defaulted on its bond payments due in July and October of that year.

Seychelles default followed a rapid increase in the country's public debt and significant arrears accumulation. At the end of 2008, the country's public debt amounted to 151% of GDP and was estimated to have risen further to 175% at the end of 2009. Seychelles was ranked among the most highly indebted countries in the world.

Most of Seychelles borrowing over the decade was external and at the end of 2008, external debt comprised 60% of the total public debt or 98% of GDP. The external portfolio comprised mainly of commercial creditors who, at the end of 2008, accounted for 61% of total external debt. Bilateral creditors accounted for a further 32% of the external debt while the remaining 8% was owed to multilateral creditors. Notably, external arrears constituted 40% of outstanding external debt or 35% of GDP. Arrears were owed predominantly to Paris Club creditors.

Given the unsustainability of its debt, the authorities negotiated a comprehensive restructuring of its official bilateral debt on Evian terms with its Paris Club creditors in April 2009. The agreement involved a 45% nominal reduction in the debt owed to Paris Club creditors, a lowering of interest rates and an extension of maturities. Subsequently the authorities signed bilateral rescheduling agreements with Malaysia and South Africa, its non-OECD creditors, on comparable terms. Notwithstanding the conclusion of the Paris Club agreement on Evian terms, the relief was insufficient to restore external debt sustainability. In an effort to secure substantial additional cash relief and further reduce the debt burden, the authorities launched a debt exchange offer with those external private creditors holding the US$230 million Eurobond, and the amortising Euro-denominated note. Certain commercial bank loans were also included in Seychelles exchange offer.

Table 4: Seychelles - Debt Dynamics Pre-Debt Exchange

	2005	2006	2007	2008	2009
		(in percent of GDP)			
Total Public Debt	147.1	139.5	146.0	151.3	161.3
of which External Debt	46.6	53.7	71.9	97.8	119.8
of which Domestic Debt	100.5	85.8	74.1	53.5	41.5
		(in percent)			
Public Sector Debt to Revenue	358.3	332.4	406.7	412.7	545.5

Source: International Monetary Fund

The Exchange Offer

On 7 December 2009, the Seychelles launched an exchange offer on US$321 million of its external debt held by private creditors. The closing date was set at January 14, 2010. The Debts affected were its US$230 million Eurobond due 2011, its €55 million note, as well as two commercial bank loans valued at US$9 million. The offer provided the option of participating in two new bonds – a new discount note and a new par note – to replace the existing instruments. The terms of the new bonds were as follows:

- *New Discount Note.* The new discount note was to be issued with a 50% discount on the principal amount. Interest was to accrue from 1 January 2010 on the basis of a stepped coupon rate ranging from 3-8%. The terms stipulated a coupon rate of 3% for the first two years, 5% for the next three years, 7% for the next three years and 8% from 2018 until 2026 when the bond matures. The note has a grace period of 6 years after which equal semi-annual instalments commencing in July 2016 and maturing in July 2026.
- *New Par Note.* The new par note was to be issued at a 100% of its face value but carry a fixed coupon rate of 2% over the life of the bond. The bond was due to mature in July 2041.

- *Goodwill Payment*. A one-off "goodwill" payment applicable to both the new par note and the new discount note in lieu of past due interest. The goodwill payment was calculated at $10.44 per $100 face value of the new notes or an estimated US$37 million. Payment was due 12 April 2010.
- *Principal Reinstatement*. The note provided for bondholders to receive an additional 25% of the face value of the new discount bond if the Seychelles failed to pass the International Monetary Fund's (IMF) first review of the 3-year Extended Fund Facility.

Box 5: Seychelles - Summary Terms Debt Exchange	
Opening Date:	▪ December 09, 2009
Expiration Date:	▪ January 14, 2010
Settlement Date:	▪ February 11, 2010
Eligible Bonds:	▪ US$230 million Eurobond due 2011
	▪ €55 million promissory note
	▪ Two commercial loans valued at US$9 million
New Bonds:	▪ New Discount Bond issued at 50% of principal value, semi-annual repayments beginning July 2016 ending July 2026
	▪ New Par Note issued at 100% of principal value and maturing July 2041
Pricing:	▪ New Discount Bond priced with stepped-up coupon rate from 3-8%
	▪ New Par Bond bonds priced at 2%.
Allocation Rules:	▪ All exchanges from old bonds to either new discount bond or new par bond
	▪ US$ 50 million threshold participation rate in new par or new discount bond
Key features:	▪ Partial guarantee on interest payments on new discount bonds
	▪ Accrued interest on old bonds paid in cash at settlement date

Source: Ministry of Finance, Seychelles

A significant feature of the exchange offer was the attachment of a partial guarantee on interest payments on the new discount note extended by the African Development Bank (AfDB). This set a historic precedent as it was the first time that a multilateral financial institution had provided a partial guarantee on a bond involved in a debt restructuring operation.

Under the terms of the policy based partial credit guarantee, the African Development Bank providing an undertaking to pay up to US$10 million in interest on the new bonds. Structured as a 16-year rolling non reinstatable guarantee, the guarantee is rolled over on each payment date over the life of the loan unless it is called. In the event that a portion is paid from the guarantee amount at interest payment date, then only the remaining guarantee would be callable at the next window interest payment date.

The AfDB's rationale for extending the partial guarantee was two-fold. First, it provided the authorities significant leverage with its external creditors in its objective of achieving a successful debt exchange and thus supported their efforts at returning the country to debt sustainability. Second, it dovetailed with the Bank's efforts to support comprehensive financial and economic reforms by the Seychelles authorities through its budget support programme. The Bank also saw this guarantee as complementary to the efforts of the IMF and other donors to restore the Seychelles medium term payments capacity and put it on a path of debt solvency.

Box 6: Seychelles – Chronology of Events in Exchange Offer

September 30, 2008	Announcement of debt restructuring
July 13, 2009	Appointment of White Oak as Financial Advisors,
August 13, 2009	Appointment of Fitch Credit Ratings Agency
September 28, 2009	Appointment of DF King as Information Agent
December 18, 2006	Launch of Offer
December 22,2006	IMF Executive Board Approves US$31.1 million Extended Fund Facility
December 23, 2009	Statement by Informal Group of Creditors supporting the exchange offer
January 14, 2007	Original closing date of offer
February 1, 2010	Fitch upgrades Seychelles rating to 'B-'
February 8, 2010	Extraordinary meeting of bondholder to implement collective action clause
February 11, 2010	Settlement Date of Exchange Offer
April 12, 2010	New bondholders to receive one-off 'goodwill' payment

Source: Government of Seychelles Press Releases

The Seychelles exchange offer met with resounding success. At closing, private creditors had voluntarily exchanged US$283 million or approximately 89% of the total eligible debt for new discount notes. Low participation in the new par notes - which did not reach the US$50 million threshold specified in the offer - resulted in the automatic reallocation of these tenders to participation in the new discount note. Significantly, 100% participation rates were achieved in all the eligible instruments under the offer save the US$230 million Eurobond. This received only an 84% participation rate. The authorities intervened by invoking the collection clause embedded in the existing Eurobond note. This effectively forced holdout creditors to participate in the exchange offer and accept new discount notes as a supermajority of existing bondholder had agreed to the terms of the exchange. The 84% voluntary acceptance and the 16% forced compliance resulted overall in a 100% participation rate for Seychelles exchange offer.

Result of the Offer

The Seychelles exchange offer resulted in significant cash relief for the country. With full participation by private creditors Seychelles enjoyed a 50% nominal reduction in its external

commercial debt eligible under the offer. The debt was also reduced in present value terms as the maturity profile of the debt was significantly lengthened and interest rates lowered. The exchange offer led to:

1. *A material reduction in the external debt stock*. With the exchange offer debt to GDP was projected at 60% at end 2010 down from 144% at the end 2009.
2. *An immediate improvement in creditworthiness*. The Seychelles benefited from an immediate upgrade in creditworthiness as assessed by the major international credit ratings agencies. Fitch ratings agency raised the long term foreign and local Issuer Default Ratings (IDRs) to 'B-' and 'B' respectively and assessed the outlook as positive. Fitch also immediately announced that Seychelles had normalised relations with the international financial community and the default "was cured".

Key Factors contributing to the Outcome

The Seychelles exchange offer benefited from a number of strategic steps and policy actions:

1. *Prior Creditor Support*. Just prior to the launch of the exchange offer, an informal group of creditors holding the existing Eurobond announced, in a creditor support letter, that they intended to support Seychelles debt restructuring effort by participating in the exchange offer. The letter came against the background of multiple rounds of discussions over a three month period between the Seychelles authorities and its creditors to implement a successful exchange. The creditors, including Banco Finantia, Cable and Wireless and Diageo, underscored the efforts of the authorities to take their views into account when finalising the offer.
2. *Partial Guarantee by the AfDB*. The financial backing and weight of a multilateral financial institution, the African Development Bank, in providing a US$10 million partial guarantee on interest payments over the life of the new bond was a significant incentive to creditors to participate in the exchange. It lowered the risk of Seychelles defaulting on its interest payments.
3. *Principal Reinstatement Clause*. The new bond contained a provision granting bondholders an additional 25% of the face value of the new discount bond (US$42.3 million) should Seychelles fail to pass the first review of its three-year IMF Extended Fund Facility at the end of 2010. The provisions provided an assurance to bondholders of government's commitment to adhere to the IMF programme.
4. *Collective Action Clause in Existing Bonds*. The implementation of the collective action clause in the existing bonds allowed the percentage of eligible claims restructured to rise to 100%.

5. *IMF Support Letter*. A letter of support by the International Monetary Fund outlining the recent economic developments in the Seychelles and the country's relations with the Fund benefited the exchange by providing and endorsement of the Seychelles economic reform efforts and the country's performance under the then existing Stand by Arrangements. It also benefited the exchange by provided an assurance to creditors of continued support and stringent monitoring by the IMF over a three-year period under the terms of an Extended Fund Facility arrangement. The letter also helped by reinforcing the need for exceptional support from Seychelles private creditors through the debt exchange if debt sustainability was to be regained.

6. *Appointment of Financial Advisors.* The Seychelles exchange benefited from continuity of expertise by appointing the same advisors who had helped them reach a successful negotiation with the Paris Club group of creditors where a 45% reduction in the debt stock had been obtained. The appointment of White Oak Advisory LLP comprised the same advisors, formerly of Houlihan Lokey, who had regrouped in the new specialist advisory firm.

7. *Transparency of Exchange Process.* In addition to on-going communication with creditors, the Seychelles authorities also maintained a webpage which provided extensive information on details of the exchange and the exchange process to creditors.

8. *Comprehensive Fiscal and Structural Reform.* The enactment of fiscal responsibility legislation and the introduction a treasury single account prior to the debt exchange along with the undertaking to implement a comprehensive programme of fiscal and structural reforms over the medium-term, provided considerable assurance to the creditor community of the authorities' commitment to fiscal prudence. The reforms included:

    a. Strengthening public financial management;

    b. Institutionalising higher governance standards;

    c. Rationalising the public sector;

    d. Bolstering the financial system; and

    e. Improving the business environment.

Post Exchange Developments

The Seychelles debt exchange has resulted in a significant debt reduction with debt-to-GDP levels projected to fall from 151% in 2008% to 60% in 2010. In a February 2010 State of the Nation address, the Prime Minister has indicated a significantly improved macroeconomic

environment.[9] Reserves have doubled between 2009 and 2010, growth is projected at 4% following an economic contraction, and the debt burden has eased. The IMF in its most recent 2010 DSA forecasts that the Seychelles debt-to-GDP will fall to 44% by 2019 with the implementation of the debt exchange and if the authorities maintain their commitment to fiscal restraint.

Conclusions

The experiences of all four countries indicate that debt exchanges can be highly effective in providing debt relief to countries with high levels of bonded debt. All four countries benefited from a reduction in debt in present value terms arising from lower interest rates and longer maturities secured under the terms of the exchange.

Significantly, debt reductions in nominal terms were not sought under the exchange offers under review except in the case of the Seychelles. Many borrowers fear that seeking a debt reduction in both nominal and present value terms may lower bondholder participation rates. The Seychelles' outcome suggests that if a strong credible case is made for debt relief backed by comprehensive financial and economic data, high participation rates can be obtained in a debt exchange even if the principal value of existing debt is discounted.

The experiences of all countries but Belize, Jamaica and Seychelles in particular, underscores the benefit of a cooperative debt exchange in which extensive consultations take place with a wide range of bondholders and where input by the affected bondholders is allowed in the design of the exchange. In all such instances, high participation rates were achieved under the debt exchange.

Jamaica's debt exchange is one of the rare cases in which a debt exchange was applied to domestic rather than external bonded debt. In the case of domestic debt, especially in a relatively shallow domestic capital market, sovereigns face the additional challenge of the threat to the overall financial stability of the country of a comprehensive debt exchange. Jamaica took exceptional care in the design of the instrument to incorporate the inputs of the exchange participants, in the simplicity of the transaction, in the transparency in the transaction, and in the technical analysis to ensure the stability of the financial sector was not compromised.

Three other factors are important in the execution of a debt exchange.

1. First, that the sovereign has available comprehensive and accurate debt data in relation to its portfolio supported by detailed macroeconomic projections to allow for the preparation

[9] From State of the Nation address by Prime Minister James A. Michel, February 26, 2010. http://www.nation.sc/index.php?dec=30

of several debt restructuring scenarios and options. The lack of comprehensive data impairs the credibility of the sovereign in making a compelling reason for debt relief to bondholders.

2. Second, while costly, financial advisors serve an important role in mapping a strategy for executing the debt exchange. Financial advisors' wide experience in debt restructuring combined with extensive knowledge of the country's debt 'story" was integral to the success of the exchanges in Belize, Jamaica and the Seychelles.

3. Finally, the authorities' commitment to comprehensive fiscal reforms and supporting policies, especially when endorsed and supported by the International Monetary Fund and other multilateral agencies, were critical to the success of the exchange. It is notable that in the case of the Seychelles a number of fiscal reforms were undertaken prior to the debt exchange to underscore the authorities' commitment to the reform agenda.

Debt exchanges will continue to be relied on as a means of restructuring bonded debt. The imperative for countries is to ensure that their debt exchange is well planned, well designed, transparent, and well executed. While it does not guarantee the achievement of long-term debt sustainability it can provide the fiscal space to move in the right direction.

PART 2 - DEBT CONVERSIONS

Debt swaps or debt conversions are another means by which countries can restructure their debt and obtain significant debt relief. Debt swaps involve the exchange of a debt, typically an external debt, at a discount for cash, assets or some non-debt obligation in domestic currency.

The main benefit of a debt swap to a borrowing country is that it results in a reduction in its outstanding debt. The extent of the debt reduction is dependent on the extent to which the creditor holding the claim is willing to discount the debt in the secondary market - its secondary market price - and the extent to which the debtor is able to redeem the debt at a price below its original face value. Unlike a simple write-off a debt, debt swaps carry an additional benefit. Because of the nature of the transaction, not only do debt swaps lead to debt reduction but they also lead to significant increases in investment or social and economic welfare.

Debt swaps can take several forms. Historically, the most common swaps have been debt-to equity swaps which involved the conversion of a portion of a country's external commercial debt into an equity investment in a new or existing enterprise within the country. However, debt swaps have expanded to include not only debt-for nature swaps but debt-for-development swaps, which include debt-for education, health and other social sector investments.

Debt for Equity Swaps

Debt-for-equity swaps typically involve three parties: the borrowing government with outstanding commercial debt, the creditor with unpaid claims, and a private investor, often a bank or private company, seeking to invest in the borrowing country. The investor purchases the external commercial debt in the secondary market, usually at a deeply discounted secondary market price and then sells it to the borrower at a negotiated value – the redemption price - close to debt's original face value. The debt is extinguished and the proceeds received by the investor in local currency are used to acquire an equity investment.

The transaction is beneficial to all parties. The borrowing country benefits from a debt reduction, an increase in investment, and not having to pay the converted debt in foreign currency; the creditor benefits by recovering a portion of his claim that was previously non-performing; and the investor benefits by obtaining additional funds to finance his projects in the borrowing country.

Debt to equity swaps were first launched in developing countries in the 1980s as countries heavily indebted to private banks sought to find ways to secure substantial debt relief unavailable through traditional channels such as the Paris Club and London Club. Chile was the first country to undertake an institutionalised debt-to-equity swap programme in 1985. Many

countries followed suit during the 1980s and at their peak in 1990, debt swap transactions globally amounted to US$28 billion.

While many countries benefited from implementing debt conversion programmes, there were a number of drawbacks associated with the programmes that raised a number of concerns about this type of transaction. Difficulties with debt-to-equity swaps pertained to the following:

1. *Fiscal Cost of Prepaying the Debt*: Debt conversions require a payment in local currency to the investor to retire the affected debt. Many of the early debt-to-equity swap programmes retired the debt in a single lump payment. As a result, already cash strapped governments faced additional constraints on their country's fiscal budgets which in turn prevented them from undertaking further debt swaps.

2. *Inflationary pressures.* Several countries experienced strong inflationary pressures due to the injection of large amounts of local currency in their economies. However, over time, debt swap programmes were modified so that limits were placed on the local currency injected into the economy at any one time in order to contain inflation.

3. *Lack of Additionality*. In a debt conversion programme, additionality occurs when the investment funds would not have been available without the debt conversion. A widely held view was that no additionality was provided by the debt conversion as the investments were already planned and would have still occurred. Governments were therefore incurring costs by subsidising a planned-for investment. However studies have shown that debt conversion programmes have been a major incentive for foreign investment and a boost for privatisation programmes.

4. *Transaction Costs*. Many governments found the transaction costs associated with debt-to-equity swaps prohibitive. These costs of administering the programme including negotiating, documenting and monitoring swap transactions were often very high. Many governments subsequently sought to address this by charging a debt conversion fee.

5. *Round Tripping*. The problem of round-tripping emerged in the debt swap programmes of a number of countries. This involved the proceeds from the debt conversion being used to repurchase foreign currency and retransferred out of the borrowing country instead of being used to cover local currency costs in the borrowing country as prescribed. Not only is the amount of foreign currency that leaves the country higher than the amount originally used to purchase the debt but no investment is realised. Among the measures governments adopted to deter round tripping was to stipulate stringent reporting requirements on the use of debt conversion proceeds. Another was to restrict participation by nationals in the country's debt swap programme.

6. *Foreign ownership*. Many debt swap programmes exclude participation of nationals of the borrowing countries giving rise to negative public perceptions about foreign ownership of national assets.

Many of the identified drawbacks to transacting debt-to equity swaps were addressed in later programmes. However, most debt swap programmes involving commercial bank debt were suspended in the 1990s as the creditworthiness of the borrowers improved and the price of the their debt in the secondary market rose to or close to the original value of the debt.[10]

A major development in debt conversions occurred in the 1990s when the Paris Club group of creditors implemented an initiative to allow all official development assistance (ODA) to be eligible for debt swaps. Bilateral debt, including official export credits, became eligible for debt swaps under the terms under the Paris Club agreements. The debts converted were to be exchanged for government support of national development and environmental programmes. Several donor governments established debt sales programmes specifically for the conversion of guaranteed export credit loans affected by Paris Club reschedulings. Activities in debt-for-development swaps and debt-for-environment swaps grew noticeably in subsequent years.

Debt-for-Equity Swaps - The Case of Jamaica and Nigeria

Jamaica

Countries such as Jamaica and Nigeria introduced debt-for-equity swap programmes in the late 1980s as a means of reducing their external debt and promoting investment in their economies.

Jamaica, a small middle income Commonwealth country, launched its debt-to-equity programme in July 1987. The explicit aim of the programme was to achieve a reduction in the public external debt and attract and generate foreign investment in designated priority sectors. The debt conversion programme was launched in a period of weak economic activity and mushrooming external debt. Over the period 1980-1985, Jamaica's debt had almost doubled from 89% to 161% of GDP. At the launch of the debt conversion programme, Jamaica's external debt amounted to US$4.0 billion or 141% of GDP. The imperative for the government was to attract foreign investment and transform the economy to one which was export driven.

Jamaica's debt conversion aimed at converting approximately US$185 million of commercial bank debt eligible for debt restructuring or approximately 50% to the total share of commercial debt. Since total commercial debt accounted for only 10% of Jamaica's total external debt, the amount slated for debt conversion was not substantial.

[10] For example, over a three year period (1987-1992), the price of Jamaica's commercial bank debt rose from $0.35 to US$0.75 in the secondary market.

Initially, the debt conversion programme only targeted debts, designated as Tranche A advances under the terms of a 1987 refinancing agreement. These had relative short maturities and were repayable over seven years. Debts clubbed as Tranche B advances were longer repayment periods with a term to maturity of 12 years. The rationale for limiting conversions to Tranche A debt was to quickly ease the debt service burden associated with these early maturities. Later modifications to the programme saw both Tranche A and Tranche B debts becoming eligible for conversion.

The original programme permitted only non-residents to qualify as eligible investors. However sanctions against residents were lifted in 1990 as the Jamaica authorities sought to deregulate and liberalise the economy. Qualified investors resident in Jamaica had to satisfy the authorities that they had sufficient foreign assets or were able to borrow overseas in order to finance the debt conversion.

The debt conversion programme provided for the proceeds from the conversion to be used in equity investments in both listed and non-listed private sector companies as well as public sector entities. The purchases of these assets, however, had to be funded through a Jamaican investment vehicle.

Investments in high priority sectors were targeted under the programme. Activities assigned high priority included construction or expansion of hotels; investment in export processing zones, the construction of factory space. Activities generating significant employment were also targeted.

Restrictions applied to the repatriation of profits and dividends overseas. Profits on new investments in priority sectors could be repatriated after three years whereas other investments were restricted to a seven-year waiting period.

Blocked deposit accounts were established for the deposit of local currency funds which the investor was not immediately permitted to remit overseas. These funds could be used for qualified equity investments as specified by the authorities (the central bank) and were carefully monitored by the authorities to avoid round tripping.

Projects under the debt conversion programmes were approved on a case-by-case basis and not through an auction system as obtained in some conversion programmes. On the purchase of the debt by an investor, the authorities would pay over local assets either in the form of equity shares, land or a local currency debt instrument, and Equity Investment bond. The value of the asset amounted to the redemption price of the debt, which was the local currency equivalent of the cancelled debt less a conversion fee capped at 10%. Equity Investment Bonds issued to the investor had the same tenor as the cancelled debt so as to minimise any inflationary pressures.

However the bonds attracted a variable interest rate benchmarked to the government of Jamaica Treasury bills plus a 2% margin. The local currency proceeds generated from the discounting of these bonds was deposited to the blocked deposit accounts.

Jamaica's debt conversion programme had mixed results. Debt cancellations were far less than the US$30 million targeted annually. Factors contributing to the weak performance were:

- Some commercial banks were unwilling to sell their claims as the loan assets were still performing;
- Delays in implementing the Equity Investment Bond which provided the Jamaica dollar funding of the equity investments;
- Inconsistent government policies which eroded investor confidence in the programme. Indecisiveness about whether the government should tie debt conversions to a hotel divestment programme generated much uncertainty about the debt conversion programme. Investors shied away from participation as they were unsure of which priority sectors would be targeted.

However, activity in the programme picked up in 1990, after some modifications, and investments increased significantly. By the end of 1992, debt amounting to US$106 million had been retired under the programme. Projects in the tourism sector accounted for 64% of the total debt converted, while export agriculture and manufactures accounted for a further 20%. The programme decelerated sharply and was ultimately suspended in 1993. The main cause was the marked rise of the price of Jamaican paper in the secondary market. Also by that time, most of the debt earmarked for swaps had already been swapped. At its closure, US$107 million or approximately 27% of the debt outstanding at the start of the programme has been converted.

Nigeria

Nigeria's debt-to-equity conversion programme was established in February 1988 against a backdrop of large central government deficits, rapidly accumulating external debt and a collapse in oil prices.

The objective of the debt programme was to reduce Nigeria's external commercial debt, repatriate flight capital and promote foreign direct investment. At its inception the scope of the debt conversion programme was relatively narrow, confining eligible debt to promissory notes and conversions limited to debt-for-equity and debt-for-cash. The proceeds of debt-for-cash conversions were allowed in respect of gifts and grants to Nigerian non-profit entities such as educational institutions, charitable organisations, religious bodies and trusts. The programme

was subsequently modified and the span of eligible debts expanded to include refinanced commercial bank debts. Debt-to- debt transactions were also allowed under the programme.

Projects under Nigeria's debt conversion programmes were mainly approved through an auction system and the first auction was held in November 1988. The amount of debt to be converted into cash or equity was determined by the Central Bank and related to the projected money/credit requirements for the year,

Forty projects participated but only eight were successful. Debt of US$40 million was converted. Auctions conducted monthly determined the value of the discount applied to the successful bids. Bidders were required to indicate the redemption price of the debt and those with the lowest redemption price or highest discount rate were successful. Successful bids were ranked in descending order, with the highest discount being allocated first, and then the next, until the total amount of local currency equivalent offered in the auction was exhausted. Between 1989 and 1990, fourteen auctions were conducted resulting in some US$311 million in debt conversions.

The Central Bank of Nigeria (CBN) provided for local currency funds to be invested in interest-bearing bonds or government securities Interest rates were in the range of 20%-25%. To curb inflation, the proceeds were only redeemed in tranches. These funds were not immediately permitted to be remitted overseas. These funds could be used for qualified equity investments as specified by the authorities (the central bank) and were carefully monitored by the authorities to avoid round tripping.

The debt conversion programme provided for the proceeds from the conversion to be used in approved sectors of the Nigerian economy. While the priority sectors targeted were manufacturing, agriculture and agricultural-related industries, hotels and tourism and building and construction were also targeted.

Despite the positive impact Nigeria's debt conversion programme had on increasing investment and employment, the impact on the huge external debt stock was minimal. While successful conversions of over US$500 million of debt took place between 1988 and 1992, Nigeria's total debt remained in excess of US$30 billion in the early 1990s.

Debt-for-Environment Swaps

Similar to debt-for-equity swaps, debt-for-environment swaps involve the cancellation of the borrowing country's external debt in exchange for local currency funding of an investment. However, in debt-for-environment swaps, the investment is the funding on an environmental project or programme. In addition, the purchaser of the sovereign debt is usually an international non-governmental conservation organisation rather than a private investor. The

international non-governmental organisation (NGO) purchases the debt (bilateral or commercial) at a discounted price in the secondary market and then sells the debt to the borrowing government at a redemption price lower than the face value of the debt but higher than the secondary market purchase price. The proceeds of the sale are used to finance the desired environmental programmes and activities in the borrowing country.

A number of countries embarked on debt-for-environment programmes in the 1990s especially as resources available for conservation were frequently cut in fiscal budgets in the wake of deepening debt difficulties. A distinguishing feature of debt-for-environment swaps was that, unlike debt-for-equity conversions, few, if any, required the repatriation of capital overseas.

The first debt-for-environment swap took place in Bolivia in July 1987. Since then the number of countries participating in debt-for environment conversions has risen significantly. In the early 1990s, a number of Paris Club creditors, including Belgium, Germany, Switzerland and the United States have initiated debt-for-environment conversions with the aim of reducing the affected debts of eligible countries and at the same time funding environmental conservation projects. For example, under the 1991 Enterprise for the America's Initiative (EAI), the US government legislated the sale, reduction, cancellation and country buyback of eligible US concessional debts as well as non-ODA official export credits owed by eligible Latin American and Caribbean countries provided they satisfied certain macroeconomic and political criteria. The EAI allowed Latin American and Caribbean countries to reduce the level of bilateral debt owed to the US government and direct a portion of the payments into supporting local environment projects. By 1993 the United States had signed agreements with 7 countries in Latin America and the Caribbean, with US$875 million in debt forgiven and the local currency equivalent of US$154 million in debt used to finance environmental programmes.

Modelled on the EAI, the US government's Tropical Forest Conservation Act (TFCA) of 1998 expanded the EAI by increasing the number of countries eligible for debt-for-environment swaps directed at tropical forest conservation.[11] The Philippines was one of the first countries to benefit when a debt-for-development swap was agreed in September 2002. The swap provided for a US$5.5 million debt cancellation with the Philippine authorities agreeing to pay the local currency equivalent of this amount over a 14 year period, to NGOs, in support of tropical forest conservation. Up to the end of 2009, some thirteen agreements have been conducted in twelve countries, generating more than US$163 million for tropical forest conservation. Potentially, up to US$12 billion is available for debt reduction or cancellation under the TFCA.

[11] Beneficiaries include Bangladesh, Belize, Botswana, Columbia, El Salvador, Guatemala, Jamaica, Panama, Paraguay, Peru, Philippines,

A major limitation of these debt-for-environment programmes was that they primarily involved concessional bilateral debts. Countries heavily indebted to commercial sources were unable to benefit from funding under the programme. In addition, the debt swap programmes counted as ODA, pushing up creditors ODA contribution without any new aid flows to countries.

Debt-for-Environment Swaps - The Case of the Poland and the Polish Eco-Fund

One of the largest debt-for-environmental swaps was achieved in 1991 under a debt rescheduling agreement negotiated between Poland and its bilateral creditors under a Paris Club arrangement. The debt rescheduled amounted to US$18 billion of which it was agreed that 50% would be cancelled and a further 10% would be written off through debt-for-environment conversions.

The Polish authorities established an independent foundation, the Polish Eco-Fund, to oversee and manage the debt-for-environment projects funded by five of the donor governments which were parties to the Paris Club agreement – France, Italy, Sweden, Switzerland and the United States. Germany, Poland's largest bilateral creditor, did not participate in the Eco-Fund since the debts that it held were export credits which, under German policy, were not eligible for conversion. The United States was the first donor to fund a debt-for-environment swap contributing about US$392 million or 72% of the total programme allocation. With the contribution of other donors, the receipts from the Polish debt-for-environment swap amounted to approximately US$500million over the period 1992 to 2007. This amount represented over 87% of the total value (US$571 million) to be invested in environmental projects over the 1992-2010 programme period.

The projects funded under the debt-for-environment swap programme targeted environmental protection and biodiversity conservation Between 1992 and 2007, grants were awarded to 1500 projects in five priority environmental areas: air, water, nature pollution, climate protection and waste management. The focus was on: reducing trans-boundary air pollution, reducing pollution in the Baltic Sea, lowering greenhouse gas emissions and protecting Poland's bio diversity, waste management and polluted land reclamation.

Payments into the Eco-Fund were relatively small in the years 1993-1994, amounting to between US$6.9 million to US$8.7 million annually. However, this amount tripled in subsequent years, as a result of a US government decision to re-profile the amounts paid into the fund, replacing a schedule of increased payments beginning in 2000 with equal, annuity payments over the period 1995 to 2010. As a result of this decision, payments made to the Eco-Fund account increased to a constant amount of US$24.2 million annually.

The Polish debt-for environment swap was striking in a number of ways:

1. *Conditionality*. The proceeds from the debt conversion were paid into an escrow account held at the Bank of International Settlements. A Board was established under the debt conversion agreement to manage the account. Unusual for debt swap agreements, a key condition of the conversion agreement was that participating creditors could veto the use of the account to finance programmes funded by Eco-Fund if Poland breached any of the terms of the agreement. The more stringent conditions associated with the agreements were due to the large size of the debt being converted.
2. *Creditor coordination and collaboration*. Poland's debt-for-environment conversion involved a coordinated debt conversions between many creditors and a single borrower country. Such collaborations have generally been infrequent in debt conversion transactions but were likely brought about by:
    a. *Political factors.* This included donors' desire to assist in Poland's transition from a socialist planned economy to a capitalist market based economy;
    b. *Economic and strategic factors.* This related to the Eco-Fund's procurement policy which offered donor country companies access to Poland's large environmental technology market. The terms of the debt swap agreement stipulated that a certain proportion of the contracts for services and inputs in funded projects had to be procured from creditor countries companies, most notably the US.
3. *Project Inspection*. A key element of the Eco-Fund's strategy was to ensure thorough inspection of the project at various stages of execution. The Eco-Fund undertook technical and financial inspections at specific stages of the project to ensue the efficient implementation of the project. Proceeds of the debt exchange were only transferred to the project after each implementation stage was approved.
4. *National capacity Building*. A noted benefit of the debt-for-environment swap was the institutional capacity acquired by the Polish Eco-Fund in efficiently implementing projects and the transfer of this capability to other public entities and non-governmental organisations within Poland.

Nonetheless the effectiveness of the programme remains debatable. The issues related to:

1. *Additionality*. A survey in the journal, *Environment and Development Economics,* published by Cambridge Press suggests that the Eco-Fund's assistance was not necessary for many of the projects implemented, as the majority of the applicants rejected by the Polish Eco-Fund succeeded in securing the funds they needed elsewhere. The debt-for-equity conversion programme may therefore not have been as cost effective as envisaged as the Polish government may have subsidised projects that would have been implemented regardless.

2. *Debt relief*. The terms of the debt conversion did not provide for a reduction in the redemption price of the affected bilateral debts. While Poland enjoyed a cancellation of its external debt, hard currency payments corresponding to the converted debt had to be provided from budgetary resources to fund the projects.

The major benefit of the Polish debt conversion was a significant increase in social investment as a result of the large number of environmental projects funded under the conversion programme. In addition, the long-term nature of the swap, the large amounts involved, and the coordination among multiple donors to create an independent common fund represented a good example of a harmonised and coordinated donor strategy which provided long-term social benefits to the beneficiary country.

Debt-for-Development Swaps

Typically, debt-for-development swaps involve the purchase of the borrowing country's debt by a development organisation, such as an international NGO or a UN agency. The debts involved are typically official bilateral debts. These debts are bought at discount from the original face value in the secondary market and then sold to the government at a redemption price below the face value of the debt. Development projects are funded by the international NGOs with the proceeds from the sale. While a number of international organisations have been involved in debt-for-development swaps, most of these conversions have been undertaken by the Canadian International Development Agency (CIDA), the Swedish International Development Agency (SIDA), the United Nations Development Programme (UNDP) and the US Agency for International Development (USAID).

A second wave of debt-for development conversions have emerged in the 2000s. While these swaps continue to aim at reducing high level of indebtedness of developing countries their focus is on funnelling increased resources towards social expenditures, particularly in health and education, in an effort to meet countries' Millennium Development Goals

Debt-for-Development Swaps - The Case of Indonesia

Indonesia's debt-for-development swap programme was established in the context of a severe external debt overhang. While Indonesia grew robustly over the period of the 1970s and 1980s, economic growth was accompanied by increased levels of external borrowing. At the time of the Asian crisis, in 1996, Indonesia's public external debt amounted to US$42.3 billion or 49% of GDP. The Asian economic crisis severely affected the Indonesian economy. Not only did GDP decrease by 13.2% but for a short period the Indonesia Rupiah lost 84% of its value.

Indonesia agreed to a substantial US$10 billion IMF rescue package to help stabilise the currency and restore investor confidence. As part of a programme of economic and financial

reforms, there was a comprehensive overhaul and restructuring of the financial system. The spate of reforms was not sufficient to stabilise the banking system and by 1998, the authorities had to intervene to rescue the country's private banking sector. In the wake of the rescue package and the financial system bailout Indonesia's public debt ballooned. By the end of 2003, total external debt had more than doubled to US$136.9 billion or almost 60% of GDP with official creditors holding US$60.7 billion in claims.

Despite high levels of external debt, Indonesia like many middle income countries was not eligible for substantial debt relief available under the Highly Indebted Poor Countries initiative. Against the backdrop of unsustainable external debt, tight fiscal constraints, and widespread embedded poverty, debt for development swaps were seen as a means by which Indonesia could reduce some of the external debt stock and ease the fiscal burden of the debt and, at the same, direct resources into key development areas such as health and education.

In 2000, Indonesia and Germany agreed in principle to undertake a debt-for-development swap based on the guidelines stipulated by the Paris Club for concessional bilateral debts. The guidelines prescribed that a Paris Club debt could be written-off if the borrowing country spent 50% of the local currency equivalent of the debt amount to support development initiatives in the sectors of education, environmental conservation or poverty alleviation. The first debt-for-development swap took place in 2002 when Indonesia signed an agreement with Germany to fund projects in the education sector. Under the swap, €12.8 million was used to found over 500 learning resource centres in various regions of Indonesia and an amount of €25.6 million was cancelled by Germany. The facilities were used to educate teachers in innovative teaching methodologies and provide new learning material. The project reached 33,000 elementary schools with approximately 5 million students. The success of the first debt swap prompted several other swaps and between 2003 and 2008, Germany cancelled debts of €68 million resulting in investments of €33 million in primary and secondary education. Germany also swapped a further €508 million for environmental projects.

While these swaps raised social investment in education, the relief was relatively small when compared to Indonesia's overall external debt and debt service burden. Even with the debt swaps, the amount cancelled amounted to less than 1% of the total debt outstanding. Notably, even with the debt swaps, Indonesia's spending on debt repayments in 2005 was eight times greater than the budgetary outlay on health and education combined.

Debt-for-Development Swaps – Tsunami Reconstruction in Indonesia

Following the 2004 tsunami, Indonesia also benefited from debt-for-development swaps with Germany and Italy for reconstruction of tsunami affected areas in certain regions of the country.

Italy and Indonesia agreed to debt-for-development swaps of US$24.2 million and €5.7 million, Germany also swapped debt with Indonesia in 2005 to assist in tsunami related reconstruction.

Other Debt-for Development Initiatives – Debt2health

Established in 2002, the UN Global Fund against HIV/AIDS, Tuberculosis and Malaria is a partnership between governments, civil society, the private sector and the affected communities. Its aim is to fight the spread of HIV/AIDS, Tuberculosis and Malaria jointly through directing financial resources in to the areas of greatest need. Mainly funded by donations, the Global Fund also sought to secure new sources of funding through a programme of debt-to-health swaps, under its Debt2Health initiative.

Under the terms of the Debt2Health agreement, the identified creditor agrees to forgo some or all debt service payments on the condition that the beneficiary government invests an agreed counterpart amount in health through the Global Fund programme. The terms stipulate that the counterpart payment cannot come from health related budgets or from expenditures by health ministries. Once the counterpart payment is received by the Global Fund, the creditor reduces the stock covered by the swap. The Debt2Health agreement comes to an end upon the successful disbursement of the counterpart payment to Global Fund programmes in the beneficiary country. Unlike debt-to-equity swaps, the Global Fund does not charge any fees or expenses related to the swap transaction. The full value of the counterpart payments goes to towards the grants that finance the project. Notably, however, debts eligible for conversion are limited to concessional bilateral debts

The Global Fund sought to identify debt-constrained countries that were not eligible for debt relief under the HIPC or MDRI debt relief programmes but were in need of debt reduction as well as resources to combat the three target diseases. Eligible countries had to satisfy a number of criteria, including: unsustainable debt levels, ineligibility for HPIC/MDRI, a high disease burden, and a reasonably solvent economy. At the onset of the programme, four countries were identified as being particularly suitable: Indonesia, Peru, Pakistan, and Nigeria. Indonesia was selected as an ideal case because of its high disease burden, its prior experience with debt-for-development swaps, and its support for the project.

The first Debt2Health agreement was signed in September 2007 when Germany agreed to cancel €50 million of Indonesia's external debt at a 50% discount. The remaining €25 million was paid in local currency equivalent to the Global Fund for approved health programmes in the country. So as to avoid a build-up of inflation, the payment schedule agreed with Indonesia mirrored the debt service payment schedule that would have been otherwise paid to Germany under the terms of the original debt.

Pakistan benefited under a Debt2Health agreement with Germany in November 2008 which involved the cancellation of €40 million of Pakistan's debt. Pakistan agreed to pay €20 million in local currency equivalent to the Global Fund over a four year period, commencing in 2009, to fund health programmes.

Conclusions

Debt conversions both reduce debt and, depending on the type of conversion, increase investments and support development projects. For many countries, the appeal of debt conversions is that it helps to achieve debt sustainability by generating economic growth whilst reducing debt at the same time. However, at its peak in the 1980s, the level of debt reduction achieved through debt-to-equity conversions, depended on the share of commercial debt held by a country. In the case of Jamaica, less than 5% of the external debt outstanding was retired through debt-to –equity conversions. Similarly, in the case of Nigeria, debt-to-equity conversions achieved less than a 1% external debt reduction. For both countries the share of commercial debt was relatively small. For countries, such as Chile and Mexico in the 1980s, significant debt reduction was achieved through debt-to-equity conversions because of the sizeable commercial debt and the deep discounts available in the secondary markets.

There has, however, been a marked shift away from debt-to-equity conversions to debt-for development swaps in the current decade. This is partly because many of the countries with high levels of commercial debt in the 1980s, have significantly reduced their debt levels and have substantively replaced commercial loan debt with bond issuance in the international capital market. Secondary market trading of commercial debt at significant discounts has waned and as a result so too has the scope for converting this type of debt. To date, bonds have not been amenable for debt conversions. Debt for development swaps emerged in the 1990s as an option for low-income countries undertaking Paris Club reschedulings. The volume of debt for development swaps has been growing since the start of the 2000s. However, for small middle-income countries with high levels of private debt, such swaps may not provide a channel for significant relief as they mainly involve the conversion of concessional bilateral debt. However, as a mean of achieving significant economic or social investments, debt-for-development swaps are an attractive way of achieving development objectives with no additional fiscal outlays and some amount of debt reduction.

PART 3 – LIABILITY MANAGEMENT INNOVATIONS

Multilateral Liability Management Initiatives

The principal objective of any debt restructuring operation is to provide some debt relief to the borrower. Over the years debt restructuring operations have related mainly to bilateral or commercial debts (more recently to multilateral debts) and have resulted in debt reductions either in the nominal value of the debt or in present value terms, when maturities are extended and interest rates are lowered. The focus over much of the 2000s has been on such relief provided under HIPC and MDRI debt relief initiatives.

For some middle-income countries a large and increasing amount of their debt is owed to multilateral financial institutions. Since the onset of the global financial crisis, this share has grown as, in the absence of access to the international capital markets and dwindling aid flows from donor governments, the only recourse has been to rely on official multilateral debt. However, multilateral loans expose borrowers to two types of market risk – currency risk as well as interest rate risk for those loans contracted at floating rates of interest. A number of recent multilateral initiatives have been implemented to assist countries mitigate these risks in their portfolios.

IADB Loan Conversion[12]

For some member countries loans contracted at floating rates of interest may constitute a large share of their holdings of multilateral debt. Their portfolio is exposed not only to foreign currency risk but also to interest risk as multilateral lending rates adjust to reflect the cost of their own borrowing in the capital markets. Because of historically low world market rates, many borrowing countries are enjoying relatively low interest payments on their multilateral debt. However, with global economic recovery, an upturn in market rates is possible as concerns shift from stimulating recovery to curbing inflation. Borrowing countries will be exposed to an increased interest service burden should rates increase.

Against this background, the Inter- American Development Bank announced a major initiative to assist member countries that wished to limit their debt portfolio's exposure to interest rate rises by providing them with the option to convert their floating-rate debt to fixed-rate obligations. While not a debt restructuring operation in the traditional sense, this initiative, "a liability-management exercise" helped to minimise risk in member countries' portfolios, providing the potential for significant relief in the event of future interest rate rises.

[12] This section relies heavily on January 15, 2009, IADB press release, "IDB borrowers can opt for interest rate conversion on $36 billion in loans", and August 4, 2009, IADB press release, "IDB undertakes $26 billion loan conversion".

In January 2009, the Inter-American Development Bank (IADB) launched a major liability management operation – the largest ever executed with its clients. The exercise allowed borrowing members to take have their IADB "adjustable-rate" loans converted to fixed rate loans to take advantage of historically low interest rates in US dollar terms. Member countries also had the opportunity to convert their non-US dollar loans into US dollar denominated debt to benefit from the interest rate conversion.

At the close of the offer, in August 2009, a total of 41 borrowing members and government guaranteed institutions accepted the offer and converted US$26 billion of outstanding debt – more than half of IADB's total loan portfolio – to new interest rates and/or dollars. The IADB recorded a total participation rate of 76% of the US$34.8 billion of loans eligible for the offer. As a result, the IADB amended 518 loan contacts in its loan portfolio in order to change the interest rates and currencies, where applicable.

The IADB's conversion offer allowed member countries and entities with sovereign guaranteed loans to convert their "adjustable rate" loans to fixed-rate loans or loans benchmarked to the three-month dollar London Interbank Offered Rate (LIBOR), or a combination of both. Used for more than a decade, IADB adjustable rate loans were loans based on the pooled cost of the IADB's market-based borrowings in different currencies. Member countries found it difficult to forecast or to hedge these loans because these calculations were based on the IADB's Currency Pooling System and were not transparent. The conversion to fixed rate loans or market based interest rates allowed borrowing members to better forecast the cost of their debt or take advantage of available financial instruments to hedge their currency and interest risks.

Issuing in Domestic Currency

Recently a number of multilateral financial institutions have initiated lending to member countries in their local currency. The African Development Bank (AfDB) began lending in South African Rand (ZAR) in 1997 and, since 2005, has included additional African currencies, beginning with the issuing of a local currency bond in the Botswana pula. In 2003, the Asian Development Bank (ADB) introduced its first lending instrument in selected local currencies, initially limited to private sector borrowers but subsequently opened to public sector borrowers in August 2005. The Inter-American Development Bank (IADB) has also been involved in local currency lending, launching a global bond denominated in Mexican pesos in April 2004. Since its inaugural bond issue, the IADB has issued other bonds in a number of Latin American currencies including Brazilian reais, Chilean pesos, and Columbian pesos. The World Bank local currency lending began in 2008 through a ZAR 58.2 million loan to the Government of Namibia in support of an educational improvement programme.

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The impetus for these institutions issuing in local currencies is the recognition that countries issuing debt in foreign currency expose their portfolios to significant currency risk. National governments earn their income predominantly in their domestic currency. Therefore, significant currency mismatches arise when governments contract debt and, as a consequence, service their obligations in foreign currency. Large shares of foreign currency debt leave governments particularly vulnerable to depreciation of the local currency as well as cross-currency volatility.

There is an abundance of empirical evidence that shows that countries with risky debt structures, in effect those with substantial foreign currency debt as well as those with significant short-term local currency debt, are more likely to have lower credit ratings, less exchange rate flexibility and higher volatility of GDP growth and capital flows. What is desirable, therefore, in terms of a safe debt structure is for governments to hold a significant share of long-term domestic currency debt in their portfolio.

For most developing countries, domestic financial resources are just not sufficient to meet government's financing requirements. Moreover, maturities in the domestic market are often much shorter and interest rates much higher than would be obtained overseas. For these countries it makes good sense, in the face of underdeveloped domestic markets, to borrow externally in foreign currency and assume the exchange risk in the debt portfolio.

A significant volume of foreign currency debt contracted by countries is used to fund projects. Extensive demand continues to exist for project financing to satisfy basic infrastructure needs as well as more sophisticated infrastructure services. With the decline in aid flows from bilateral donors and the limited access of many developing countries to the international capital markets, there is increased reliance on multilateral financial institutions to meet the large financing requirements of infrastructure investments. Yet, at the same time, projects funded with foreign currency debt typically generate their revenues in local currency, creating a currency mismatch between the government's assets and its liabilities. Multilateral financial institutions have faced increasing pressure from their members to address this problem.

Lending in local currency carries twofold benefits. Firstly, it has reduced currency mismatches, as both the debt liability and the income generated by the asset are denominated in the same currency. Secondly, it has helped foster domestic capital market development by opening new markets and providing diversification opportunities for local institutional investors such as insurance companies and pension funds.

Nonetheless, multilateral financial institutions face constraints in local currency lending. Foremost among these, is the availability of local currency. This may be constrained by the size of the market. A second constraint is the cost competitiveness of the local currency lending. Ideally, the multilateral financial institutions should finance borrowers at a cost lower than that which they themselves could obtain by accessing the local market. This may not be the case for a country's central government that may be able to borrow at a cost similar or lower than that offered by multilateral institutions. This applies even though the multilateral may have a higher credit rating simply because, in the local market, investors perceive the sovereign as the best credit (virtually risk free) in local currency because of its ability to print money. This may explain why much of multilateral lending in local currency has been to the private sector or public sector entities.

However countries with high currency risk exposures can benefit from multilateral institutions lending in local currency as it would insulate the portfolio from such currency movements. The challenge for these institutions is raising funds in the local market at rates less than the government would obtain. While this may be difficult, it may not be impossible if multilateral institution use their leverage as a triple "A" rated issuers to pull in new investors into domestic markets.

Debt Exchange Warrants

Debt exchange warrants are financial instruments that give the holder the right, but not the obligation, to exchange on a specific date, the "exercise date", foreign currency bonds for local currency bonds.

The Case of Mexico

Mexico was the first sovereign to sell debt exchange warrants in the international capital markets. Mexico's debt management objective was to change the currency composition of its public debt portfolio and reduce its holdings of foreign currency debt substituting it for peso denominated debt. The transaction was also intended to lengthen the maturity structure of the domestic currency debt. It was also an opportunity to determine the extent to which foreign investors would be willing to participate in Mexico's local bond and money markets without the risk of a failed local currency issue in the international capital markets.

In November 2005, Mexico issued debt exchange warrants that gave holders the option to swap US$2.5 billion for peso-denominated debt with longer maturities. In November of the following year, warrant holders had exercised the option and exchanged the full US$2.5 billion for peso denominated debt. In exercising the warrant, the rate of conversion was established at a pre-

determined ratio, equal to the ratio of forward prices for both types of debt, on the day of the issue. The face value of the local currency debt was determined by the exchange rate on the day of the exchange was applied. While the exchange resulted in the average maturity of the debt being extended by some 18 months it did lead to a marginal increase in debt service costs.

Since its first issue in November 2005, Mexico has issued three subsequent debt exchange warrants between March 2006 and April 2008. The April 2008 debt exchange warrant entitled holders to exchange US$1.25 billion of various foreign currency bonds for peso-denominated and inflation-indexed bonds.

Outcome of the Debt Exchange Warrants

Mexico's issuance of debt exchange warrants has been hugely successful in improving the currency composition of the debt by substituting external foreign currency debt for domestic currency debt. This has significantly reduced the exchange rate risk associated with the public debt portfolio. In addition, the debt exchange warrant has achieved a reduction in the external debt (although domestic debt has risen significantly). Mexico, through its debt exchange warrant, has achieved the following:

1. A broadening of its investor base for domestic bonds with new foreign investors;
2. Reducing foreign currency debt and therefore exposure to foreign currency risk;
3. Lengthening the maturity of domestic currency securities and thereby reducing interest rate risk;
4. Lowering the cost of domestic debt because of the broader investor base and more liquid market.

Conclusions

Debt exchange warrants, interest rate conversions, and domestic currency issuance are useful liability management tools which result in an improved debt structure and help to reduce borrowing countries exposure to exchange rate, interest rate and rollover risk.

Many borrowing countries are highly vulnerable to exchange rate risk given the underdeveloped nature of their domestic securities market and the high share of foreign currency debt in their public debt portfolios. Many of the recent DSAs conducted by the IMF point to the vulnerability of many countries to foreign currency movements as well as domestic currency depreciation. These financial instruments may be very useful ways of reducing these exposures and avoiding a debt crisis.

PART 4 – OTHER INNOVATIVE FINANCIAL INSTRUMENTS

Many small countries are particularly vulnerable to external shocks, which often lead to steep economic losses and marked volatility in their medium-term growth performance. Sharp rises in debt levels are frequently associated with shocks arising from adverse terms of trade, declines in imports by trading partners, adverse developments in commodity prices, weak growth and natural disasters. For many countries, especially small states, debt sustainability is substantially undermined and often full blown crises emerge.

Small vulnerable countries with high levels of indebtedness could opt to index their debt to real variables, such as GDP or exports, or to some of their underlying determinants, such as commodity prices, imports or natural disasters to hedge against these exposures. Bonds indexed to GDP, exports or other real variables carry two main benefits:

- The immediate benefit to countries of real variable indexation is that they better correlate to a country's ability to pay thereby reducing the likelihood of defaults and debt crises. Unlike conventional 'plain vanilla' bonds, changes in the indexed variable (GDP, exports, commodity prices, imports, natural disasters) would lead to automatic adjustments in debt payments. Payments would increase when there was an upturn in growth or exports but be lower than those paid on a conventional bond in the event of a slowdown. Key sustainability indicators such as debt-to-GDP, debt-to exports, and debt service to exports would be stabilised.
- An additional benefit of indexing bonds to real variables is that they can help to stabilise government spending. Since smaller debt payments are made at times of slower growth, pro-cyclical fiscal spending is limited. In effect, real indexed bond reduce governments' need to cut expenditures when growth slows and help restrain spending during periods of rapid growth. More stable government spending could help to stabilise economic growth and over time raise long-term growth rates for many vulnerable countries.

While real variable indexed bonds can mitigate the impact of external shocks by stabilising expenditures and helping to reduce a country's risk of debt distress, to date, they have only been issued by sovereign borrowers on a limited scale. Including these instruments in a government's debt portfolio may be particularly advantageous to highly vulnerable small countries especially in view of the recent earthquakes in Asia, Latin America and the Caribbean, the rise in world oil and food prices, and the protracted global slowdown that has dominated world economic developments.

Indexed bonds linked to real variables can be grouped into two main categories: those linked to real variables partially within the control of governments, such as GDP and export volumes, and

those linked to real variables beyond the control of the authorities, such as commodity prices and natural disasters. Some of these innovative financial instruments merit further consideration.

GDP Indexed Bonds

Growth or GDP indexed bonds are bonds that link a country's debt payments to their rate of economic growth. They benefit the issuing country by reducing their debt burden in the event of an adverse shock that affects growth. Increased debt payments only occur in an economic upturn. As such, growth indexed bonds are better tailored to a country's capacity to repay.

Most conventional bonds issued by developing countries are fixed rate bonds where interest payments remain unchanged over the life of the loan regardless of any change in economic conditions. In contrast, growth indexed bonds are designed for payments to adjust to changes in the growth rate. Indexed bonds are structured to take into account two factors: the expected or base economic growth rate and the interest rate applicable to bonds generally issued in the market, typically a conventional fixed rate bond. If the economy was expected to grow by 5% and conventional bonds carried fixed rates of 7%, then a growth indexed bond could be structured to pay an additional 1% of interest for each 1% of growth above the expected growth and 1% less in interest for each 1% decline below the base growth rate. These bonds would also include an additional interest premium, of say 1%, to compensate investors for such factors as lower liquidity, or the greater variability in interest payments. The growth indexed bond may therefore have a base rate of 8% compared to the rate on comparable conventional bonds of 7%. If the economy underperforms and growth is say 3% below the expected growth rate, the amount paid in interest falls commensurately, with the rate on growth indexed bonds declining 3% below the instrument's base rate. If robust growth occurs, exceeding expectations then there is a corresponding rise in interest rates and debt payments increase. Government spending is restrained in high growth/high revenue periods as a result of higher debt service payments and eased in low growth periods reducing the need for spending costs.

Despite the obvious benefits of growth indexed bonds, concern about issuing these instruments persist. Among the concerns are the following:

1. *GDP measurement*. Concerns surround the quality and accuracy of GDP data in many developing countries. The argument prevails that deficiencies in many national statistical agencies prevent them from producing comprehensive, accurate, reliable and timely GDP data critical in calculating payments on growth indexed bonds. Other concerns are that governments may deliberately underreport growth or pursue policies to slow growth in order to reduce required payments during economic upturns.

Concerns about data inaccuracies can be readily addressed. One means is to develop the capabilities of such offices through technical assistance provided by donor governments or multilateral financial institutions. Alternatively, an external agency, such as an international institution could verify or certify the GDP data for the purpose of these calculations.

Since strong economic performance is so closely linked to political approval and re-election there is little to suggest that the political authorities in any country would seek to underreport growth so as to understate debt payments.

2. *Revisions and Methodological changes*. Concerns relating to GDP data revisions and how to treat with changes in data due to additional information or as a result of methodological changes have also limited issuance. Revisions complicate payments calculation and fears are that they could lead to underpayments of debt is growth is revised downwards.

   By basing debt payments on growth estimates at a certain date and ignoring revisions, this problem can also be readily addressed. In the event of a revised methodology, the authorities can simply maintain a separate GDP series based on the old methodology until the relevant bonds reach maturity.

3. *Market illiquidity*. Concerns about whether growth indexed bonds will have sufficient liquidity is well placed. An illiquid market for growth indexed bonds will prevent the instrument from being actively traded and will risk a high interest premium being demanded by investors.

   High volumes of growth indexed bonds would need to be issued by the issuing country to address the problem of liquidity. However this may not be feasible for many small countries given their market size and volumes as well as the newness of the instrument. Since small initial issues by a country may not be attractive and may not be sufficient to avert a debt crisis – the purpose for which the instrument was intended – one option is to have multilateral financial institutions purchase a share of the newly issued bonds to guarantee a minimum market size. Alternatively, several countries could issue growth indexed bonds simultaneously in a regional rather than national market. Conceivably, multilateral institutions could play a coordinating role in regional issues helping to ensure broad market span and acceptability. Growth indexed bonds can also be issued as part of a debt restructuring exercise creating a ready market and greater liquidity in the instrument. A number of countries (Argentina, Bulgaria, Bosnia and Herzegovina, and Costa Rica) have issued their first growth indexed bond through this route.

4. *Pricing*. Investors may be reluctant to purchase growth indexed because of the complexity of their pricing. Moreover, these bonds may be difficult to price because of the limited availability and quality of market-based GDP forecasts.

   A standardised pricing model possibly formulated by international financial institutions could address this concern. Data capture and reporting could similarly be improved with the assistance of these institutions thereby both improving the reliability of GDP statistics from national institutions as well as improving the actual marketability of the instruments.

5. *Premium over standard bonds*. Growth indexed bond are typically priced at a premium above the rate of standard/conventional bonds. The premium is designed to compensate investors for initial market illiquidity or interest payment volatility. When growth rates meet expectations, these instruments are more expensive than their conventional counterparts. Issuers may be reluctant to issue growth indexed bonds so as to avoid this cost.

   Since first or early issuers are likely to pay a higher premium that late issuers, there is a 'first movers' problem, one option may be to undertake coordinated issuance across countries thereby increasing market liquidity.

6. *Callability*. Many conventional bonds include provisions for issuers to call the bond. In effect, the issuer is allowed to repurchase the instrument if its pricing makes it become too costly. Investors' concerns about growth indexed bonds are that countries would call the instruments during high growth periods, preventing investors from obtaining the anticipated higher debt payments. The benefits would be asymmetric with the government benefiting in an economic downturn without investors benefiting in an upturn.

   Structuring growth indexed bonds as non-callable instruments would avert this problem.

Recent experiences with growth indexed bonds highlight some of the concerns raised about their issuance and widespread market acceptability but also point the way in which these issues have or can be resolved.

Country Experiences

Bosnia and Herzegovina, Bulgaria and Costa Rica have all issued growth indexed bonds in the 1990s as part of Brady bond restructurings. These bonds were not thought to have been well designed and their performance has been mixed. Argentina, in 2005, also issued growth indexed bond (growth linked warrant) as part of its debt restructuring exercise.

Bulgaria

Under the terms of the agreement, Bulgaria's growth indexed bond payments were triggered if:

- GDP reached 125% of its 1993 level; and
- A year to year increase in GDP was recorded.

Where these conditions were met, 50% of the year's GDP growth rates were paid on the underlying principal amount in addition to the conventional coupon amount. However, in the design of the indexed bond, the definition of the source of the reference data and the GDP unit of measurement was ambiguous. The source data was either:

a. The World Tables of the World Bank, or

b. Any other publications in which the World Bank published GDP data.

Serious problems arose when a published edition of the World Tables produced four measures of GDP, in current and constant prices, and using market and factor prices all in local currency units.[13] The trigger conditions were further complicated when the World Bank replaced the World Tables with the World Development Indicators, publishing GDP in both constant and current prices and in US dollars and Bulgarian leva.

The Bulgarian authorities chose to use constant value local currency units and as a result, growth indexed payments were never triggered. Had GDP in current value in US dollar of leva terms been applied, growth indexed payments would have been triggered.

Bosnia and Herzegovina

Bosnia and Herzegovina's growth indexed bonds were designed so that payments were triggered if:

- GDP reached a predetermined level and remained at that level for two years; and
- GDP per capita rose above in US$2,800 in 1997 units, adjusted for German consumer price inflation.

The main issues with this bond were:

- The poor quality of existing data, aggravated by the existence of a large informal sector which was not included in official GDP statistics; and
- The perceived unreliability of population statistic, which were one of the variables upon which the trigger for payments was based.

[13] This is covered in detail in Miyajima, Ken (2006), *How to Evaluate GDP linked Warrants Price and Repayment Capacity*, IMF Working Paper (WP/06/85).

The Case of Argentina

Some ten years later, in June 2005, Argentina issued a 30 year growth indexed bond as part of its debt restructuring programme. The structure was much improved in comparison to those issued in the 1990s.

The bond, a growth indexed warrant, was structured as follows:

1. *Maturity*. Growth indexed bond maturing in 30 years.
2. *Principal repayment*: Payments on peso principal converted to US dollars, Euros or Yen at the time of payment.
3. *Warrant payment*. An annual payment of 5% of the difference between actual GDP and threshold GDP in nominal terms during the relevant year.
4. *Trigger Conditions*: Payments triggered when:
    a. Actual GDP, expressed in constant peso terms, as at the reference date exceeds threshold GDP; and
    b. Annual rates of actual GDP, expressed in constant peso terms, as of the reference date, exceed 3%.
5. *Basis of Calculation*: The value of debt payments is calculated on November 1 each year. The GDP reference date is December 31 of the year preceding the calculation date.
6. *Call option*: Bond not callable.
7. *Other Features*: GDP warrants detachable from bond and tradable.

Argentina's growth indexed bond appears to have been better designed and enjoyed greater success than the earlier bonds. However, some problems have emerged.

- *Complexity of calculations*: The complexity of the calculations is believed to have led to significant under-pricing of the bonds.
- *Potentially large upside payments*. The instrument design could lead to larger than desired payments when Argentina is only slightly over-performing.

Catastrophe Bonds

Many small countries are highly vulnerable to natural disasters which often lead to substantial economic losses and declines in economic growth. Studies indicate that the impact of natural disasters tends to be higher the smaller the size of the country and the lower the degree of economic development of the country.[14] For many small developing countries, particularly small islands, the impact can result in losses valued at more than a year's worth of output[15].

Coping with the costs associated with a natural disaster is beyond the scope of many of these countries. Public finances are quickly over whelmed as sources of revenue are disrupted and unanticipated spending for recovery, rehabilitation and reconstruction rise significantly. Many small countries turn to external donors for support in the immediate aftermath of a disaster. However aid from external donors usually arrives after considerable delay, as donors take time to pledge resources and even longer to disburse them. Often too, other countries requiring emergency assistance may be competing for these resources. The recent episodes of earthquakes in Haiti followed by Chile underscore this problem. Even with the receipt of aid, many countries face income declines and steep rises in their debt levels. The outcome too often is an increasing debt-to-GDP ratio and a payments crisis.

Governments can take steps to mitigate the adverse impact of natural disaster on their public finances and on overall debt sustainability. One means is to issue real variable indexed bonds. However, issuing growth indexed bonds is unlikely to compensate for the losses arising from a natural disaster as often the decline in economic growth is not commensurate with the loss incurred as a result of a natural disaster. In the absence of, or as a supplement to, catastrophic insurance, catastrophic bonds may present governments with a viable alternative.

Catastrophe bonds or 'cat' bonds are a possible means by which small, disaster-prone developing countries can insure themselves against natural disasters. Cat bonds are typically structured as floating rate securities which pay an attractive yield to investors but waive some or all of the interest and principal repayments when a specific, predetermined event such as a natural disaster occurs. Cat bonds therefore transfer some of the risk to a country's public finances from a natural disaster to the purchasers of the bond.

A key feature of catastrophe bonds is that they are collateralised. The principal amount of the bond is placed in an escrow account and invested on behalf of the investors. Alternatively, and more commonly, a special purpose vehicle (SPV) is created on behalf of the issuers or sponsor

[14] See IMF (2004), *report on Sovereign Restructuring through* Crisi
[15] Grenada's losses were estimated at 200% of GDP in the aftermath of Hurricane Ivan in 2004.

and the capital received from the bond is invested in low-risk securities. The return from these investments is paid to investors who also receive a premium from the issuer.

Catastrophe bonds provide for investors to forfeit part or all of their interest and principal in the event of a specified catastrophe. Critical to the design of the catastrophe bond therefore is specifying the trigger point which voids payment to the investor. There are four main types of triggers:

1. *Indemnity*. Indemnity triggers are based on the issuer's/sponsor's actual loss from an event above a specified threshold. This trigger most closely resembles traditional insurance protection.
2. *Modelled loss*. Modelled loss triggers rely on catastrophe modelling software in which an exposure portfolio is created and in which actual data is input when a catastrophe occurs. If, based on the actual data, losses generated by the model exceed a specified threshold; the payment provision under the catastrophe bond is triggered.
3. *Parametric*. Parametric triggers are indexed to the natural hazard rather than to the actual loss claims of the issuer. The parameter may be wind-speed in the case of a hurricane, ground acceleration or intensity in the event of an earthquake or some other objective and peril appropriate benchmark. The catastrophe bond is triggered if the actual event parameters exceed the pre-established threshold parameters. Catastrophe bonds with parametric triggers agree, *ex ante,* the payment amount on the occurrence of a triggering event.
4. *Parametric Index*. The parametric index combines parametric data with loss calculations determine the specific threshold. The parametric index uses catastrophe modelling software to calculate losses due to the input of certain parametric data collected from multiple reporting stations. If the loss exceeds a specified threshold then the payout function for the bond is triggered.

The tenor of catastrophe bonds is typically between two to four years, with the most common tenor being three years. The preference for this tenor reflects investor sentiment that three years is not overly long in terms of the market's illiquidity and issuers view that fixed transaction costs can be spread over a number of years.

Benefits of a Catastrophe bond

Catastrophe bonds provide two benefits:

1. *Debt sustainability*. Catastrophe bonds allow for debt payments to decline in the event of a catastrophe and therefore promote debt sustainability.

2. *Fiscal Space* Catastrophe bonds provide governments have more fiscal space for disaster recovery without having to curtail spending because of revenue declines or a slowdown in economic growth. Since catastrophe bonds are collateralised, governments have the earmarked funds at their disposal for recovery spending.
3. *Portfolio diversification.* Catastrophe bonds allow investors to diversify their portfolio, especially since the return on the bond is largely uncorrelated with the return on conventional bonds or on equities.
4. *Higher returns.* Catastrophe bonds also provide opportunities for investors to hold higher yielding instruments as loan as payment changes are not triggered.

Concerns

Concerns about the catastrophe bonds generally pertain to the following:

1. *Cost*. A major concern among issuers is the cost associated with catastrophe bonds. Costs are much higher as catastrophe bonds pay higher interest rates to compensate for the risk of the loss of interest and/or principal. Issuers are concerned that debt payments would be considerably higher than that for a conventional bond especially in the event that the disaster does not occur.
2. *The trigger*. Investors are often concerned about the choice of trigger and that issuers do not design triggers in a way that places them at a disadvantage. Investors express a preference for index and parametric triggers as these are more likely to be manipulation-proof than indemnity triggers and can be more readily verified.
3. *Liquidity*. The low level of liquidity relative to conventional bonds may be of considerable concern to investors. However, the size of the catastrophe bond market has grown rapidly in recent years. The bond market is estimated at US$14 billion in 2009.
4. *Market size*. The size of the market is also of concern particularly to issuers. The fear is that there may be insufficient demand for catastrophe bonds because of the relatively small size of the market.

The Case of Mexico

Since their emergence in the 1990s in the aftermath of Hurricane Andrew, catastrophe bonds have been issued mainly by reinsures in international capital markets. However, Mexico in May 2006 was among the first sovereigns to successfully issue a catastrophe bond. Mexico issued the bond to protect itself against earthquake risk as the first step in a comprehensive plan to insure itself against natural disasters, including hurricanes.

The issue comprised two components. It comprised straight parametric insurance under which the government would receive payments in the event that an earthquake of a certain magnitude hit prescribed regions over a specified three years. It also comprised two catastrophe bonds structured as follows:

- *Principal value*. The two catastrophe bonds had a total face value of US$160 million.
- *Compensation*. The principal value of the catastrophe bonds when added to the monetary compensation provided by the insurance contact totalled US$450 million in compensation, with US$150 million contingent on occurrence of an earthquake in each region.
- *Cost*. The catastrophe bond carried an annual spread of 230 basis points. The insurance premium amount to approximately US$14 million.

Reportedly, Mexico's catastrophe bond took almost three years to structure largely because of the country's budgetary approval process. More recently, in October 2009, Mexico issued US$290 million in catastrophe bonds under a new programme initiated by the World Bank – the MultiCat programme.

The World Bank "MultiCat" Programme[16]

A major initiative in the catastrophic bond market occurred in late 2009 when the World Bank announced the launch of its catastrophe bond issuance "MultiCat" programme. The programme is designed to:

- Help governments and other public entities access the international capital markets in order secure affordable insurance against natural disasters;
- Enlarge the traditional investor base for catastrophe bonds by offering yields that are not correlated to financial markets; and,
- Ensure government's access to immediate liquidity to finance emergency relief and reconstruction work after a natural disaster.

It is the first programme of its kind and is designed specifically to help governments from developing countries.

The MultiCat programme has the following features:

1. *Multiple perils*. Participants are allowed to buy insurance coverage from multiple perils, including earthquakes, floods, hurricanes and other wind storms. The pooling of different

[16] Relies heavily of the World Bank Press Release No 2010/100 "World Bank Launches "MultiCat Program"

risks is designed to attract new investors, enlarge the investor base and lower the insurance premium over time.

2. *Documentation*. All bonds issued under the World Bank programme carry the MultiCat brand name and use a common legal structure and documentation.
3. *World Bank as Arranger*. The World Bank will act as arranger for these transactions. Issuing countries are expected to benefit from the Bank's expertise in identifying and pooling risks as well as its experience in pulling together highly complex transaction and attracting a broad range of investors.
4. *Special Purpose Vehicle*. The World Bank will use a special purpose vehicle that writes parametric insurance contracts for governments and public entities to issue the catastrophe bond. The SPV will invest the proceeds in AAA-rated assets which form the source of payouts if specified event occurs. If no event occurs, the SPV returns the entire principal to the investor. However, as with catastrophe bonds in general, if a disaster occurs, the investor relinquishes part or all of his principal to the government who may then use it for recovery spending.
5. *Target Investors.* The World Bank will place the bond with institutional investors through various investment banks.

The Mexico MultiCat Bond 2009

Mexico issued US$290 million in a series of catastrophe bonds under the World Bank's MultiCat programme. Four bonds were issued and were designed to protect against earthquake as well as Pacific and Atlantic hurricane risks in three regions around Mexico City. A special purpose vehicle was used to issue the instrument. Each bond had a maturity of 3 years

All transactions were oversubscribed and distributed among investors in Bermuda, Europe, Japan and the United States.

Conclusions

Real indexed bonds and catastrophe bonds are innovative financial instruments that can help minimise countries potential for debt distress. They also help alleviate the effects of economic volatility by minimising the burden of debt service payments when countries are financially constrained either due to adverse economic shocks or due to natural disaster. Small countries may find these instruments a useful addition to their menu of options.

However despite these advantages, issuance of real-indexed bonds is negligible and demand for sovereign issues is low. Countries will need to determine ways to:

1. Increase issuance. The launch of the World Bank's MultiCat programme may be a step in this direction.
2. Encourage new investors by increasing the market volume.
3. Examine way to reduce the transaction costs associated with these instruments.

If properly structured, real-indexed bonds may provide a useful means to help countries not already in debt distress to maintain their debt at sustainable levels. The involvement of international financial institutions may provide the leverage to advance the use of these instruments by highly vulnerable countries.

PART 5 – KEY LESSONS LEARNED AND THE WAY FORWARD

Many middle-income countries are facing high and unsustainable levels of public debt. Because of their middle-income status, debts contracted by these countries are often non-concessional commercial credits with little scope for relief under the Paris Club. Rescheduling commercial debt through the London Club is also of limited benefit to many middle-income countries as, in contrast, to the 1980s, debt to private creditors has been contracted in the form of securities through the international capital markets rather than through the syndicated loan market. Historically, bonds have been extremely difficult and costly to restructure because they are held by multiple investors, who are generally not homogenous but separated by institutional sector, region, investment size and motive. On the face of it, the options for highly-indebted middle-income countries are limited to traditional restructuring mechanisms – debt rescheduling, debt refinancing and debt exchanges. Moreover, the scale of the relief is much smaller than would be obtained by a similarly highly-indebted but low-income country. The scale of the relief secured under the HIPC and MDRI initiatives have gone a far way in helping low-income countries achieve long-term debt sustainability. Yet, as this paper shows options, some fairly novel, are available that can help put middle income countries debt on a sustainable path. These options range from mechanisms that lead to an absolute nominal reduction in the debt or those that reduce the debt in present value terms, to instruments such as real indexed bonds that help maintain debt sustainability or other instruments that help manage risk exposures in the portfolio.

As this paper shows country experiences have been mixed. For most countries, debt exchanges have resulted in reduced debt levels in either nominal or in present value terms. While debt exchanges have typically been applied to external commercial credits, as the case of Jamaica shows, debt exchanges can successfully bring about a significant domestic debt relief. Dominica's case highlights, however, that debt exchanges carry the risk of holdout creditors which can seriously compromise the success of the exercise.

Based on the country experiences a number of lessons were learned about key factors for a successful debt exchange. These include the following:

1. *Close creditor dialogue and cooperation*. Debt exchanges conducted within a framework of close creditor involvement seem to have been the most successful in achieving the stated objective. This was particularly noted in the case of Belize, Jamaica and the Seychelles.
2. *Financial advisors*. The role of financial advisors seems essential in the process of carving out an implementation and communication strategy. It is particularly important to select

financial advisors who have a strong track record in sovereign debt restructuring and who have sound local or country knowledge.

3. *Transparency and Well Developed Communication strategy.* Belize, Jamaica and the Seychelles made substantial financial and economic information available to creditors and the general public. These three countries ensured the availability of information on their official websites. It was particular noticeable that Belize, Jamaica and the Seychelles developed an information strategy to accompany their financial strategy.

4. *Well structured transaction.* A well designed transaction is essential to the success of the exchange. On-going dialogue with creditors who are knowledgeable about financial structures is vital.

5. *Comprehensive and accurate debt data.* An area that should not be overlooked as the availability of comprehensive and accurate debt data and in particular those that are affected by the debt exchange. Dominica encountered noted problems in the timing of the exchange because of inadequate debt information and delays in data reconciliation.

6. *IMF Support Letter.* Letter from the IMF appeared to provide significant leverage in prompting creditors to accept the terms of the exchange. It also provided comfort to the creditors as to the extent of the authorities' commitment to economic and structural reform.

7. *IMF programme.* An economic programme with the IMF seal of approval carries significant weight in creditors deciding to support a debt exchange. Creditors are not likely to proceed with the exchange unless they can gauge the authorities' commitment to a programme of economic reform and fiscal restraint to avoid a repeat of debt difficulties.

8. *Partial Credit Guarantees.* The AFDB's partial credit guarantee to the Seychelles was a considerable boost to the debt exchange as investors had a further assurance of receiving their payments. Such guarantees offered as part of a small countries debt exchange exercise could contribute significantly to its success.

9. *Multilateral Involvement*. Even though multilaterals are generally not a party to debt restructurings, the case of the participation of the CDB in Dominica's collaborative debt exchange does indicate that multilateral financial institutions are willing to be flexible, if only on a case-by-case basis. Their explicit support or tacit pressure through pre-conditionalities (as in the case of Jamaica and the IMF) is a key determinant in the outcome of the exchange.

Debt conversions have provided success, albeit limited, in achieving, a nominal debt reduction as well as contributing to national development. In order to maximise the benefits from a debt conversion, these steps should be contemplated:

1. *Extent of Debt Reduction*. To benefit from debt conversions, the country's portfolio should have a significant share of debt eligible for conversion. For many countries, these are mainly concessional bilateral debt which can be targeted for debt-for-development or debt-for environment swaps. At present, the scope for debt reduction through conversions of commercial debt appears more limited given the small share of loans relative to bonds in many country's debt portfolios.

2. *Domestic Debt Capacity.* Debt conversions often involve the extinguishing and replacement of external debt by domestic debt. Countries with high domestic debt burdens may find that debt conversions may be a costly way in which to retire external debt.

3. *Additionality*. Debt conversions have been criticised for not creating any additional investment as much of the investment would have occurred even without the conversion. The key concern is that the quantum of debt relief under debt conversions is relatively small. Governments should not be seen to be using scarce revenue to subsidise an investment that would have, in any event, taken place, especially where the subsidy is more substantial than the debt relief. Countries should seek to ensure that the debt conversions supplement rather than replace intended investment.

4. *Multi-donor effort*. The Polish Eco-Fund demonstrates that creditors can coordinate their efforts and make debt conversions more cost-effective. Countries should seek to encourage such collaborative efforts as a) they increase the level of development aid at any particular point in time b) lead to higher debt reductions, and c) lower transaction costs.

Few countries have issued real-indexed bonds. However, they provide a good way of helping countries highly vulnerable to external shocks mitigate these risks and maintain stable debt-to-GDP levels. Based on country experiences, it will be important to:

5. *GDP Measures*: Ensure that GDP measures are clearly specified in the terms of agreement and that as in the case of Bulgaria there is no ambiguity.

6. *Callability*: To enhance the marketability of the instrument, issuers should ensure that the call option embedded in many bonds is removed. This will help to assure investors that they will receive a increased return when there is economic growth and that the government will not exercise the call option, thereby reducing or eliminating the payments when interest rates decline

Highly indebted vulnerable countries should seek to familiarise themselves with these options so as to maximise the options at their disposal.

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APPENDICES

Appendix 1: Details of Small Commonwealth States

Country	Region	Income Level (2008 GNI per capita)	Public Debt (% of GDP, 2008)	Geography	Population (millions, 2008)	Income Per Capita (2008)
1. Antigua and Barbuda	CAR	High	90.8	island	0.1	13,620
2. Bahamas, The	CAR	High	47.7	island	0.3	17,160
3. Barbados	CAR	High	105.9	island	0.3	9,330
4. Belize	CAR	Lower middle	77.3	mainland	0.3	3,820
5. Botswana	AFR	Upper middle		landlocked	1.9	6,470
6. Dominica	CAR	Upper middle	86.9	island	0.1	4,770
7. Fiji*	PAC	Upper middle	53.2	island	0.8	3,930
8. Gambia, The	AFR	Low	47.6	mainland	1.7	390
9. Grenada	CAR	Upper middle	102.2	island	0.1	5,710
10. Guyana	CAR	Lower middle	92.5	mainland	0.8	1,420
11. Jamaica	CAR	Upper middle	109.9	island	2.7	4,870
12. Lesotho	AFR	Lower middle	52.4	landlocked	2.0	1,080
13. Maldives	ASI	Lower middle	68.6	island	0.3	3,630
14. Malta	EUR	High	63.0	island	0.4	16,680
15. Mauritius	AFR	Upper middle	49.9	island	1.3	6,400
16. Namibia	AFR	Upper middle	22.0	mainland	2.1	4,200
17. Papua New Guinea	PAC	Lower middle	26.6	island	6.4	1,010
18. Samoa	PAC	Lower middle	30.3	island	0.2	2,780
19. Seychelles	AFR	Upper middle	151.3	island	0.1	10,290
20. Solomon Islands	PAC	Lower middle	24.0	island	0.5	1180
21. St. Kitts and Nevis	CAR	Upper middle	177.6	island	0.0	10,960
22. St. Lucia	CAR	Upper middle	67.3	island	0.2	5,530
23. St. Vincent and the Grenadines	CAR	Upper middle	67.5	island	0.1	5,140,
24. Swaziland	AFR	Lower middle	11.5	landlocked	1.2	2,520
25. Tonga	PAC	Lower Middle	36.4	island	0.1	2,560
26. Trinidad and Tobago	CAR	High	27.2	island	1.3	16,540
27. Vanuatu	PAC	Lower middle	17.3	island	0.2	2,330

Source: Commonwealth Secretariat/IMF/World Bank

*Fiji Islands was suspended from membership of the Commonwealth on September 1, 2009

Key: Africa (AFR), Asia (ASI), Caribbean (CAR), Europe (EUR), Pacific (PAC).