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# Understanding Sovereign Debt

Options and Opportunities  
for Africa

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Understanding Sovereign Debt — Options and Opportunities for Africa

The African Legal Support Facility (“ALSF” or “Facility”) is a public international institution hosted by the African Development Bank (“AfDB”). The ALSF is dedicated to providing legal advice and capacity building to African countries on complex commercial contract negotiations, creditor litigation and other related sovereign transactions.

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Making a Difference

# Understanding Sovereign Debt

Options and Opportunities for Africa



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# Foreword

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## AFRICAN LEGAL SUPPORT FACILITY FACILITÉ AFRICAINE DE SOUTIEN JURIDIQUE

Since the debt crisis of the 1980s, the debt sustainability of African countries has been a constant, and sometimes controversial, topic of discussion. In the early 2000s, many African countries recognised the need for, and worked towards, a significant reduction in their sovereign indebtedness through debt relief programs, improved fiscal governance, and commodity-based economic growth.

More recently, however, slow economic growth, diminished commodity prices, revenue volatility, exchange rate depreciation, and a general rise in expenditures have all contributed to a sharp increase in public indebtedness across the continent.

Contemporaneously with this trend, a decrease in the availability of concessional lending has encouraged several African countries to find new ways to finance their activities and projects. With private and non-traditional bilateral lenders becoming increasingly common, the typical composition of African sovereign debt has changed, introducing new and complex lending structures and terms. Along with new lenders, more active trading of African debt in an increasingly complex and dynamic secondary market has raised new challenges for sovereign borrowing.

The accumulation of debt has unfortunately already led to tenuous debt situations in several countries, with the International Monetary Fund reporting in 2017 that 15 of Africa's countries were either in debt distress or at high risk of debt distress (IMF World Economic Outlook Database).

It is important to note that incurring debt is not an inherently bad policy. Indeed, sovereign borrowing allows countries to finance much-needed infrastructure projects and social programmes, and enables countries to succeed in attaining their development goals. Nonetheless, while sovereign debt can be an effective economic growth catalyst for governments, mismanagement of that debt can have the opposite effect, pushing governments into precarious situations with longstanding economic consequences.

Key to avoiding the negative ramifications associated with incurring debt is developing and implementing sustainable debt strategies and robust debt management frameworks that will facilitate the effective long-term management of debt.

One of the primary reasons for the establishment of the African Legal Support Facility (ALSF) was to help African governments avoid the pitfalls of excessive debt accumulation and to support them in their quest to achieve debt sustainability. Since its establishment, the ALSF has assisted African governments in understanding complex sovereign debt related contracts. The ALSF also provides advisory services and capacity-building support to enable African governments to successfully negotiate fair and balanced contracts with creditors, to adequately defend themselves against vulture fund litigation, and to create effective debt management strategies and frameworks.

It is within the above context that the ALSF has developed this handbook, designed to serve as a practical, accessible guide for public debt managers and others involved in public financial management in Africa. It aims to empower these individuals by demystifying the complex concepts and terminology related to sovereign debt and by identifying and outlining tools that may be used to successfully manage debt.

The first part of the handbook discusses the concepts that form the foundation of sovereign debt, such as the technical, financial, and legal aspects related to debt instruments and the markets in which they are traded. The second part outlines the development and implementation of strategies related to debt financing, as well as

tools and methods that can be employed to prevent debt distress. The authors conclude by addressing the subject that the handbook intends to help governments avoid – crisis – and offer guidance on what to do if one occurs.

Our group of authors, all of whom contributed their time and expertise on a *pro bono* basis, include academics, economists, financial advisors, researchers, and lawyers from multilateral organisations and leading international law firms from around the world with extensive experience in debt issuance, sustainability and restructuring. Together with colleagues from the ALSF, these authors have created a resource that provides a well-balanced, multi-disciplined perspective on sovereign debt management in an easily digestible format.

It is our hope that this handbook will empower African governments to better understand, utilise and manage their debt. We also hope it will encourage further discussion and scholarship. It is not, however, a substitute for obtaining professional advice.

While Africa's debt issues are indeed unique, the current concerns raised by Africa's potential debt vulnerabilities are universal. Sound public debt management is essential for all governments, and the processes and procedures related to it are substantially the same, regardless of the country to which they are applied. As an African institution, the ALSF has created this handbook for African governments, but its content is no less applicable outside of the continent.

On behalf of the ALSF, I wish to thank all of the contributing authors for their enthusiasm, passion, and commitment during the development of this handbook. While the process was intense, it was fuelled by vast experience, dedication, tenacity, and healthy debate. The handbook reflects the views and collective voices of these experts, as well as those of key African stakeholders.

I also wish to thank the West African Institute for Financial and Economic Management (WAIFEM), the Macroeconomic and Financial Institute of Eastern and Southern Africa (MEFMI), the Collective Africa Budget Reform Initiative (CABRI) and the U.K. Overseas Development Institute (ODI) for their support on this important project. More specifically, I wish to thank the group's remote advisors, Tivinton Makuve (MEFMI) and Johan Krynauw (CABRI), for their indispensable contribution to the handbook.



The handbook was produced using the “Book Sprint” method, which facilitates the development and drafting of a complete book in just five days. I would also like to thank the Book Sprints team (<http://www.booksprints.net/>) - Faith Bosworth, Barbara Rühling (facilitators) and Henrik van Leeuwen (illustrator) for their sturdy stewardship and creativity throughout the process.

Finally, I express thanks to the strategic and logistic planners: Toyin Ojo and Nicole Kearse (ALSF), Ronald Tafadzwa Chari (formerly ALSF, now World Bank), and Mohamed Badissy from the Commercial Law Development Program (CLDP), who took this handbook from concept to development.

The handbook is available in both electronic and printed form (currently in English and French).

**Stephen Karangizi**  
**Director and CEO**  
**The African Legal Support Facility**

## **THE AFRICAN LEGAL SUPPORT FACILITY**

The African Legal Support Facility (ALSF) is an international organisation which broadly aims to remove asymmetric technical capacities between public- and private-sector stakeholders. The ALSF was originally established in response to the rise in vulture fund litigation against African sovereigns, but quickly moved into assisting African governments in the negotiation of complex commercial transactions. The ALSF intervenes in matters related to the sovereign debt, power, infrastructure, and extractive sectors.

***[www.aflsf.org](http://www.aflsf.org)***

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## Disclaimer

This handbook is the collective product of its authors. No single view expressed in this handbook should be attributed to any individual author and none of these views necessarily represent the views of any of the institutions and organisations (or their respective governors, directors, managers and clients) where each author works.

This handbook is an overall guide and does not contain definitive financial or legal advice. Readers considering any of the issues discussed in this handbook should seek to speak at an early stage with their advisors.

# Introduction

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This handbook is intended to empower public debt managers and other officials involved in public financial management in Africa by demystifying relevant concepts and terminology and by serving as a practical guide to public finance.

Throughout the handbook, generally accepted terms from the Task Force on Finance Statistics have been used to ensure consistency and clarity. For the purposes of this handbook, the term “public debt” is sometimes referred to as “sovereign debt” or other similar terms. Equally, a country may be referred to as a “sovereign”, “nation”, or “government”.

Public debt management has elements of both “science” and “art”. The “science” is comprised of the technical, financial and legal aspects of debt instruments and the markets in which they are traded. The “art”, however, is how public debt managers develop and implement strategies related to debt financing, and determine how much to borrow, which resources to use, how to structure them, with whom and how to interact, how to prevent debt distress, and crucially, what to do if a crisis hits.

The first 13 chapters of this handbook focus on that “science”. In this context, the broad reasons for borrowing debt, the various sources of financing, and the instruments that are most commonly used are examined. The second part of the handbook, chapters 14 through 17, considers both the science of public debt management (the functions, frameworks and tools available to debt managers and

issues related to data management) as well as the art of public debt management (the process for developing a debt strategy).

A specific chapter has been dedicated to the “Role of Advisors”. Independent, professional advisors for financial, legal and communications assignments play a critical role in assisting governments in achieving their objectives, not just in crisis. This chapter will examine the function of these advisors, and consider how and when they should be procured.

Finally, in the third part of the handbook, chapters 18 through 20, we describe the art of navigating times of debt distress and how to recover and restore resilience to the country.

# 1 Landscape of African Sovereign Debt

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With the world's youngest population, abundant natural resources, and rapidly growing economies, the African continent is currently at a crossroads of opportunities and challenges. It is clear that to achieve their potential, African countries will need significant investment in their human and physical capital, whether it be in education, health, infrastructure or, more critically, power. However, their ability to converge the necessary financial resources without mortgaging their future will be key to the success of their developmental goals.

The World Economic Forum estimates that the continent will require USD 100 billion annually to finance infrastructure investment. In order to meet these demands, countries in Africa need to both mobilise their own domestic capital and attract an enormous amount of external resources. Most of these resources, both domestic and international, will be in the form of debt.

Debt, in its many varieties — official, private, long term, and short term — has helped some countries on the African continent to develop their infrastructure, exploit their natural resources, improve the health and education of their people, and contribute to their overall economic growth. However, despite receiving HIPC relief in the past,

many countries have quickly accumulated new debt and are at high risk of debt distress.

The authorities on the continent are now well aware that debt does not come without associated risks. The growth of debt across the continent must be complemented by well-designed macroeconomic policies and robust debt management processes and institutions. Where policies, processes and institutions are weak, the debt carrying capacity is low.

## Historical Context

For decades, Africa's economic growth was stunted as a result of unsustainable debt accumulation and serial restructurings. However, the debt relief initiatives of the 1990s, such as the Highly Indebted Poor Country (HIPC) initiative and Multilateral Debt Relief Initiative (MDRI), restored debt sustainability, thereby bringing African countries into the investment map.

### **The HIPC Initiative and MDRI**

The HIPC initiative was launched in 1996 by the World Bank, the International Monetary Fund (IMF) and other multilateral organisations with “the aim of ensuring no poor country faces a debt burden it cannot manage”. The initiative, which was enhanced in 1999, has provided exceptional assistance to eligible countries to reduce their external debt burden to sustainable levels; this has enabled them to service their external debt without the need for further debt relief, and without compromising growth. In 2005, the HIPC initiative was supplemented by a new programme, MDRI, launched that year by the African Development Bank, the World Bank and the IMF. The aims of the joint HIPC and MDRI initiatives are now nearly completed, with HIPC closed to new entrants in 2011 and MDRI was terminated in 2015 .

The HIPC and MDRI initiatives have assisted 36 participating countries (of which 30 are in Africa) to cancel over USD 99 billion in external

debt. Debt relief under the HIPC and MDRI initiatives has enabled these countries to increase their poverty-reducing expenditures by substantially alleviating debt burdens, reducing debt service payments, and improving public debt management.

The HIPC and MDRI initiatives included the following African countries as eligible recipients: Benin, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Comores, Côte d'Ivoire, Democratic Republic of the Congo, \*Eritrea, Ethiopia, Ghana, Guinea, Guinea-Bissau, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Niger, Republic of Congo, Rwanda, Senegal, Sierra Leone, \*Somalia, \*Sudan, Tanzania, The Gambia, Togo, Uganda, and Zambia.

\*Have not fully benefited. These three countries have benefited from Decision Point relief, but not Completion Point relief (a nuance we did not highlight about the HIPC Initiative), but it is wrong to say that they have not benefited at all.

## Post-HIPC/MDRI Debt Levels

The aim of the HIPC and MDRI initiatives was to provide debt relief with the objective of lifting the burden of unsustainable debt and ending the vicious cycle of the debt trap. The combination of debt-relief initiatives and responsible macroeconomic policies in most countries in the region resulted in economic growth and sustainable debt levels. However, this trend is starting to reverse, and public debt as a percentage of GDP is on the rise across Africa. As at January 2019, the IMF and the World Bank estimate that 13 countries in the region are at high risk of debt distress and 5 are already in debt distress.



## **FACTORS THAT HAVE CONTRIBUTED TO THIS DEBT INCREASE INCLUDE:**

1. The 2014-2016 price weakening of African export commodities, including oil.
2. Failure to generate sufficient additional tax revenues to repay the debt raised to fund development and infrastructure.
3. Shocks in the migration of liabilities – such as losses by state-owned enterprises – to the public-sector balance sheet.
4. Exchange-rate depreciations.
5. For some countries, poor institutional governance at the level of tax administration and debt management.

Due to budget constraints in their own countries, traditional providers of grants and concessional financing have fewer resources available for developing countries. This has forced African countries to seek alternative sources of financing. Due to the global low interest rate environment and higher commodity prices, African countries have had greater access to market-based financing, which is more expensive, usually has shorter maturities, and is likely to become scarce in times of debt distress.

African countries – even some of the poorest – have been able to issue bonds on the international capital markets. Many of the bond-associated obligations are governed by non-domestic law, constraining the ways in which the debt can be managed in extraordinary times.

A substantial proportion of this new African debt is denominated in foreign currency; this exposes economies to currency shocks and minimises their ability to plan currency devaluation. Even debt denominated in domestic currency is mostly held by non-residents, as a result of insufficient development of domestic financial markets, which makes it more difficult to rollover in times of distress.

However, growing debt stock and debt service should not be interpreted as signals of an inevitable future crisis and inability to pay. This is where robust debt management in the context of sound macroeconomic policies can make a huge difference.

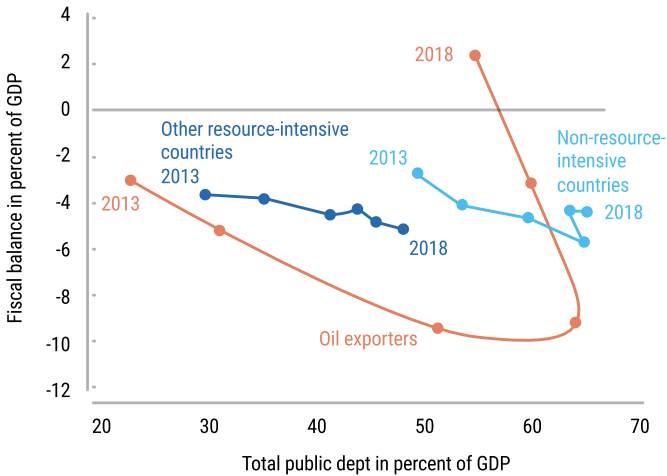


FIG.1. Source: IMF World Economic Outlook Database

## Recent Trends

African public debt managers today face certain topical issues including:

### INCREASING ACCESS TO INTERNATIONAL CAPITAL MARKETS

As of March 2019, 20 sub-Saharan African countries had issued bonds in the international capital market, most of them denominated in USD, the most recent debut issuer from Africa being Benin. Since most African bond issuers are unable to access tenors longer than 5-7 years, this could result in a spike in maturities in 2024-2025. Overall the external foreign currency debt of African countries increased from USD 237.57 billion in 2005 to a total of USD 524.12 billion in 2017.

## **INCREASING PRESENCE OF NON-TRADITIONAL CREDITORS**

Recent years have witnessed a sharp increase in lending to African countries from non-traditional creditors, including China, India, Saudi Arabia, Islamic Development Bank and other institutions in the Gulf and Asia.

For example, Chinese lending to sub-Saharan African public and private sectors has reached USD 60 billion in 2018. This lending by Chinese state-owned banks or by the Chinese government itself has been made on both concessional and non-concessional terms.

## **PRESENCE OF OTHER NON-TRADITIONAL COMMERCIAL CREDITORS, SUCH AS OIL TRADERS**

The dependence of many African countries on specific marketable commodities has attracted multinational trading groups who are interested in long-term commitments and supplies of these commodities. Of these commodities, oil is the largest and has attracted the most interest. For example, certain national oil companies have entered into pre-financing agreements with multinational trading groups, in one case representing approximately 30% of the country's external public debt.

## **IMPORTANCE OF STATE OWNED ENTERPRISES (SOES) AND SUBNATIONAL DEBT, AS WELL AS GUARANTEED AND OTHER CONTINGENT DEBT**

The growth of SOE financial liabilities, subnational debt, guarantees and other contingent debt is an important factor for governments and debt managers to take into account when considering macroeconomic policies and debt management strategies. In this context, guaranteed and other legally committed liabilities must be closely monitored in case the legal commitment of the sovereign to pay is triggered. Sovereigns must also monitor SOEs and subnational debt even when they are not legally obliged to support it. An inability of these SOEs or subnationals to roll over their maturing principal debt obligations may well require the sovereign to step in to ensure the continuous provision of basic goods such as energy and water, or services such as banking. This could have a serious impact on the sovereign's balance sheet and overall finances.

## LACK OF PROPER RECORDS, TRANSPARENCY AND GOVERNANCE FAILURES

A number of African countries are facing challenges in their debt management because of (a) a lack of proper recording of the full stock of the sovereign's actual and contingent debt liabilities, (b) a lack of transparency, sometimes, of key financial commitments, and (c) governance failures due to either a lack of proper processes and structures or, sometimes, to corruption. Structuring debt management agencies with clear powers and governance ability to address these challenges must be one of the priority goals of African sovereigns.

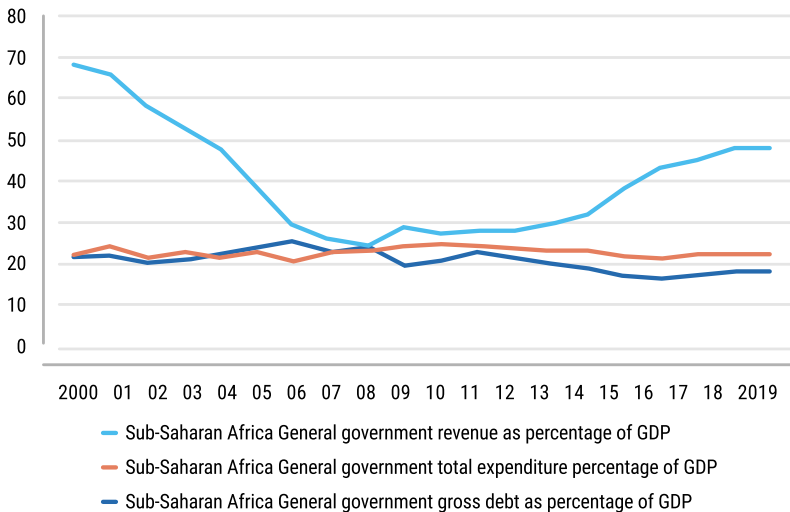


FIG.2. Source: IMF World Economic Outlook Database



# Types Of Creditors



## *Key Points*

*A sovereign borrower has different financing options, each of which will have one or more creditors.*



*The different types of creditors of a sovereign usually include multilateral creditors (e.g. the World Bank, African Development Bank, the IMF), bilateral creditors (e.g. Paris/non-Paris Club creditor countries), commercial creditors (mainly banks although there are others) and bondholders (domestic and foreign).*



*Understanding the types of creditors and their underlying goals and structures, their various legal frameworks, and policies to their financing provision, will ultimately help sovereign borrowers comprehend who the players are and where they can borrow funds.*



*Lenders active on the continent continue to change in recent years and there has been an increase in lending from “non-traditional” sources, e.g. plurilateral creditors (WADB, TDB, BEDEAC, etc.).*





## 2 Multilateral Creditors

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Multilateral creditors are organisations with global memberships that leverage funds contributed by their members to promote economic growth and stability. Multilateral Development Banks (MDBs), such as the World Bank and the African Development Bank (the AfDB), typically have a mandate to reduce poverty and advance sustainable development through funding policy development and economic activity.

The International Monetary Fund (the IMF) is a multilateral institution that is mandated to promote international monetary and financial stability, through monitoring member countries policies and national, regional and global economic and financial development, providing financial assistance to members to address balance of payments problems, and providing technical assistance to help member countries build better economic institutions.

Multilateral creditors are governed by their relevant legal and policy frameworks, and may provide financing on both concessional or non-concessional terms. This chapter provides a brief overview of the three most prominent (and most active) multilateral creditors in the African market.

## The African Development Bank Group

The African Development Bank Group (ADB Group) is comprised of three entities: the AfDB, the African Development Fund (ADF) and the Nigerian Trust Fund (the NTF).

### **THE AFRICAN DEVELOPMENT BANK**

The AfDB, founded in 1963, is an MDB with the mission of reducing poverty and improving economic conditions in Africa. Originally, only African countries were permitted to join the bank, but since 1982 membership to the AfDB has been open to non-African countries as well. The AfDB pursues its mission by providing financing – to African governments and private companies investing in the bank's regional member countries (RMCs) – for projects and programmes that are expected to contribute to economic and social development in Africa.

### **AFRICAN DEVELOPMENT FUND**

The ADF was established in 1972 and commenced operations in 1974. The ADF promotes economic and social development in the 38 least-developed African countries. Unlike the AfDB, the ADF provides funding on a concessional basis for projects and programmes.

### **THE NIGERIAN TRUST FUND**

The NTF, a self-sustaining, revolving fund created in 1976 by agreement between the ADB Group and the Nigerian government, provides concessional financing to the AfDB's low-income RMCs in order to assist those countries in their development efforts.

## The International Monetary Fund

Established in 1945 as one of the Bretton Woods institutions, the IMF's mandate is to promote the stability of the international monetary and financial system. In discharging its mandate, the IMF with 189 members monitors the economies of its member states, provides financial assistance to countries with balance of payments problems, and supports sound macroeconomic policy through technical assistance.

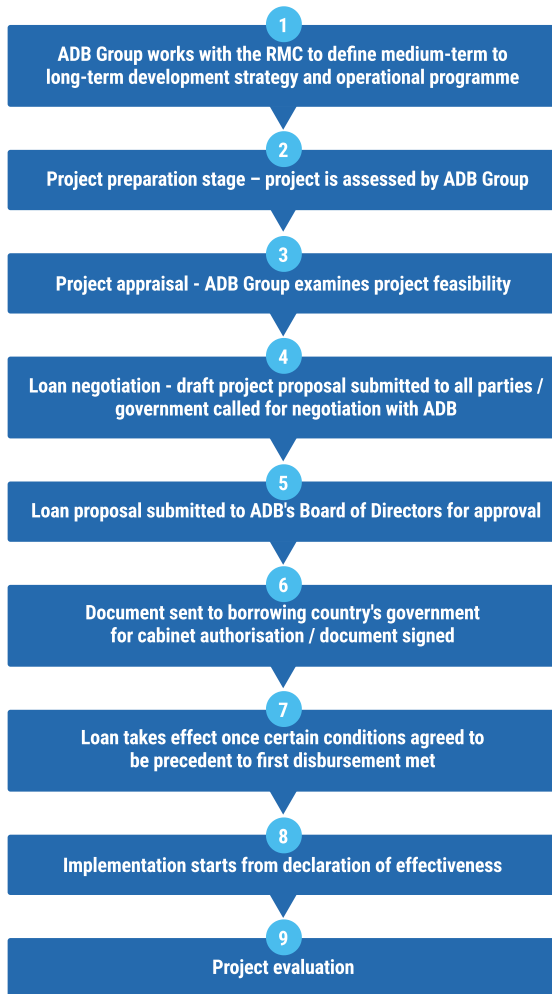


FIG.3. ADB Group Project Cycle

To carry out this mandate, the IMF may provide financial assistance to member states in line with two requirements established by its Articles of Agreement:

1. Financial assistance is used to resolve the member's balance of payments problem, and cannot be provided for any other purposes. A member may use the Fund's general resources only to the extent it has a balance of payments need, i.e. a need arising from its balance of payments or its reserve position or developments in its reserves. (Article V, Section 3 (b))
2. The member will be in a position to repay the IMF in accordance with the relevant maturity schedule. (Article V, Section 3 (a))

These conditions, while distinct, are related, because the resolution of a member's balance of payments problem will enhance its capacity to repay the IMF.

In order to deploy financial assistance to member states, those members must implement a programme of economic, financial, and structural reform designed to address the underlying balance of payments problem. In practice, following a request from a member country, an IMF staff team holds discussions with the authorities to assess the economic and financial causes of the balance of payments problem and the amount of financing necessary to remedy the problem. The member government and the IMF then agree on a programme of economic and structural policy adjustments. This reform programme is presented to the IMF's Executive Board to approve a financial arrangement in support of the programme. Following approval by the Executive Board, the member may then access financing from the IMF as long as it meets the conditions of the reform programme, which is referred to as "conditionality". Implementation of the reform programme is monitored by the Executive Board through reviews.

The World Bank Group, established at the same time as the IMF, is an international development organisation with 189 member countries. Its goal is to reduce poverty by lending money to the governments of its poorer members to finance development projects. The World Bank Group's primary lenders to sovereigns are the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA).

The IDA is responsible for helping the world's poorest countries. Overseen by 173 shareholder nations, the IDA aims to reduce poverty by providing loans and grants

for economic development programmes designed on even more favourable concessional terms than the IBRD. For more information on the terms available from these institutions, refer to the Chapter “Multilateral and Bilateral Financing”.

## A Note on Preferred Creditor Status

Multilateral institutions generally enjoy preferred creditor status (PCS) over all other creditors. PCS, which is a *de facto* preference and not a legal one, originates in the context of debt restructuring by the Paris Club, where official bilateral creditors have been willing to exclude multilateral creditors from the restructuring process, thereby allowing them full recovery of arrears prior to the restructuring of other sovereign debts and liabilities. This treatment reflects the public good nature of multilateral financing – for instance, the IMF provides assistance in situations where the member state may have no other source of financing, and seeks to guide the member state through a reform programme that is intended to help the member put its public finances and debt on a sustainable trend. In addition to favourable treatment by the Paris Club, multilateral lenders have also been accorded PCS status by private creditors, as the public good aspects of multilateral lending normally also benefit them. .

It is important to note that recent years have witnessed an increase in lending from other institutions that have recently been referred to as “plurilaterals”. As the number of these new entrants increases and the lending becomes more important, questions have arisen as to whether all of these plurilaterals and regional organisations should be designated as true multilaterals.

This is a very recent debate and can cause confusion for debt managers and policy makers.

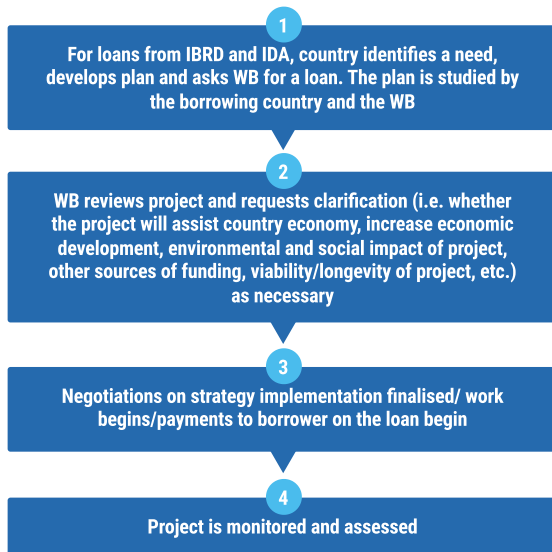


FIG.4. The World Bank Project Cycle

# 3 Bilateral Creditors

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A sovereign entity lending to another sovereign is considered to be a bilateral creditor. Bilateral creditors can be broadly categorised as traditional bilateral creditors and emerging, non-traditional bilateral creditors. A common distinction between the two is membership in the Paris Club, where traditional bilateral creditors are members, while emerging, non-traditional bilateral creditors are not.

This section will discuss both types of creditors: how are they organised, the philosophies around the provision of development assistance, and the terms and modalities used for delivering development assistance to developing countries. For a deeper discussion about the types of instruments they provide, refer to the Chapter “Multilateral and Bilateral Financing”.

Importantly, this section also highlights how issues of debt sustainability are considered by these two categories of bilateral creditors as they lend to developing countries, and provides a brief description of the key sectors these two bilateral creditor categories have largely targeted.

## Traditional Bilateral Creditors (Paris Club)

Traditional bilateral creditors focus on long-term debt sustainability and keep an eye on macroeconomic linkages. This may include lending to LICs at affordable terms (concessional) to support sustainability and policy reform. Traditional bilateral creditors consider policy conditionality on institution-building and governance as essential for the efficient use of development assistance.

### **PARIS CLUB**

Although they consider themselves an “informal” group, The Paris Club is a group of official bilateral creditors that has met regularly in Paris since 1956 and considers the debt of developing and *emerging* countries. Their monthly “Tour d’Horizon” discussions are an important forum where participants discuss the external debt situations of debtor countries and methodological issues regarding the debt of developing countries.

Paris Club member countries participated fully in the HIPC Initiative and provided significant (and in many cases, total) debt relief to eligible debtor countries. They have also provided significant relief to non-HIPC eligible countries over the years, and as a result the current level of debt outstanding by African sovereigns to Paris Club creditors is less than it was in the past.

### **PERMANENT MEMBERS OF THE PARIS CLUB**

There are currently 22 permanent members of the Paris Club: Australia, Austria, Belgium, Brazil, Canada, Denmark, Finland, France, Germany, Ireland, Israel, Italy, Japan, South Korea, the Netherlands, Norway, the Russian Federation, Spain, Sweden, Switzerland, the United Kingdom, and the United States of America.

The Paris Club is looking to expand its permanent membership over time to take into account increased bilateral official lending from “non-traditional” sources, such as China, India and Saudi Arabia.



## AD HOC MEMBERS

Non-member official creditors can also actively participate in the monthly Tours d'Horizon discussions or in negotiation sessions, subject to the agreement of permanent members and the debtor country. *Ad hoc* members have included Abu Dhabi, Argentina, Kuwait, Mexico, Morocco, New Zealand, Portugal, South Africa, Trinidad and Tobago, and Turkey (see [www.clubdeparis.org](http://www.clubdeparis.org)).

## OBSERVERS

The Paris Club allows observers to attend Tours d'Horizon discussions and/or negotiation meetings, including:

1. Representatives of international institutions (the IMF, the World Bank, Organisation for Economic Co-operation and Development, United Nations Conference on Trade and Development, European Commission, the AfDB, Asian Development Bank, European Bank for Reconstruction and Development, Inter-American Development Bank).
2. Non-Paris Club, non *ad hoc* member countries that have claims on a particular debtor country. These countries may attend as observers the Tour d'Horizon, when the discussion focuses on that debtor country and the negotiation meetings with that country, to support productive activities and their own national companies.

## Emerging, Non-Traditional Bilateral Creditors (Non-Paris Club)

Emerging, non-traditional bilateral creditors are becoming increasingly important as providers of both concessional and non-concessional financing to borrowers on the African continent. These entities may provide financing to developing countries directly, or through government agencies, state-owned banks, and other entities.

In contrast to other bilateral creditors, these emerging creditors tend to focus on micro-sustainability of individual projects rather than on the debtor country's macroeconomy. Rather than providing the government with direct budget support, these creditors concentrate lending on certain sectors of the economy, most notably in the infrastructure sector, to support productive activities.

Importantly, these emerging creditors take a different view with respect to conditionality and adhere to the principle of non-interference in the internal affairs of recipient countries.

Major non-traditional official lenders include China, India and Saudi Arabia.

### **A WORD OF CAUTION**

Several emerging creditors participate in the Paris Club as *ad hoc* members on a case-by-case basis, or as observers. However, in the process of a restructuring, many non-Paris Club bilateral creditors may behave very differently from the traditional creditors. History has shown that non-Paris Club creditors have often resisted the principle of comparability of treatment, as defined and implemented by the Paris Club.

Instead, these creditors have often chosen to address any payment difficulties of debtor countries on a bilateral basis, which can complicate the comprehensive resolution of a sovereign debt problem.

What does this mean for debtor countries? In times of trouble, it can mean more difficult restructuring negotiations with official creditors, since the debtor does not benefit from the collective approach. This can complicate the process of solving bilateral, and often politically sensitive, issues between sovereign debtors and their official creditors.

# 4 Commercial Creditors

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Private sector financial institutions and other commercial creditors offer an important source of financing to sovereign borrowers. However, unlike multilateral or bilateral official creditors, commercial creditors provide funds to the sovereign borrower on commercial terms determined by market forces. Commercial debt, usually in the form of loans and guarantees, is not concessional or policy-based financing but is instead provided for the purposes – and on the terms – agreed by negotiation between the sovereign debtor and commercial creditor.

Commercial credit agreements may include:

1. Provisions ensuring that they are covered if their cost of funding increases (e.g. an “increased costs” clause) or if their return is reduced because of market, regulatory or tax changes (e.g. “tax gross-up and tax indemnity”).
2. Undertakings seeking to protect the status of their credit (e.g. a “negative pledge”, “*pari passu*”).
3. Provisions enabling them to terminate for serious cause (“events of default, including cross default/acceleration”).
4. In syndicated credits, provisions regulating intercreditor matters such as sharing of recoveries and voting.

5. Provisions allowing the assignment, transfer or novation of the rights and obligations of the creditors to third parties.

Multilateral and official lending facilities (other than with the IMF) are likely to contain most of the above provisions, other than (4) and (5).

Both domestic and foreign lenders provide commercial debt to sovereigns. Domestic commercial obligations are typically governed by the domestic law of the relevant sovereign, while foreign commercial obligations are typically governed by English, New York or other foreign law. The choice of domestic or foreign law can have important legal consequences.

Domestic commercial debt may be provided in the form of credits extended by regulated banks, pension funds, asset managers, institutional investors or (in some cases) wealthy individuals or families resident in the country in question. The credit extended can be denominated in domestic or foreign currency, depending on the exchange control regime and other circumstances of the relevant sovereign.

Foreign commercial debt may be provided in the form of a credit extended by a single foreign bank to the sovereign (a “direct loan”), or by a syndicate of banks (a “syndicated loan”). Syndicated loans provided by a small group of banks with a longstanding relationship with the sovereign, and an intention to keep the loan on their books to its maturity, are sometimes also called “club loans”. In the case of a syndicated loan, one or more banks will act as the arrangers of the financing, bringing other banks into the transaction through a marketing and syndication process. These financings were historically described as “London Club” financings because they were typically arranged by London-based banks.

In recent years, the spectrum of foreign creditors who participate in commercial debt financings for sovereign borrowers has expanded to include a variety of unregulated institutional investors, such as pension funds, asset managers, and institutional investors. These investors provide direct lending facilities to sovereigns, bypassing the regulated financial institutions that have historically intermediated such facilities. Such investors are often able to offer commercial debt products on a more flexible basis than regulated banks and other financial institutions.

## 5 Bondholders

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The international and domestic capital markets have emerged as an important source of financing for all sovereigns. In recent years, private investors have shown an increased interest in the debt markets of sub-Saharan Africa. In addition, the domestic capital markets of African markets are developing and are making an increasing contribution to the funding of African sovereigns.

Debt securities, issued in the local market in the form of short-term paper (treasury bills or treasury bonds), or internationally in the form of Eurobonds, are either privately placed or publicly offered to investors. Debt of this nature can be denominated in either local currency or foreign currency. For most African countries, local currency denominated debt securities are only available in the domestic capital markets and in the sub-regional market for CFA denominated debt securities. Foreign currency denominated debt securities can be issued either in the domestic capital markets, if there are local investors with the ability to invest in foreign currency, or in the international capital markets.

Where a domestic capital market exists, this is often an attractive source of financing for the sovereign. Domestic banks and other institutional investors (such as pension funds and insurance companies) are typically the largest category of investors in local treasury bond and treasury bill markets. They are desirable investors from a sovereign perspective because they will typically decide – or be encouraged or required by the sovereign to decide – to retain their investments in a crisis.

Specialised international investors (e.g. pension funds, hedge funds, and asset managers) looking for exposure to local currency denominated debt are increasingly participating in local debt markets as well. In the absence of capital controls, these international investors may be more inclined to withdraw their investments in anticipation or during a crisis, which can accentuate liquidity and other problems for a sovereign at a moment of vulnerability.

In recent years, the bulk of non-concessional financing for sovereigns has been extended through the issuance of Eurobonds and other debt securities – directly issued or guaranteed by sovereigns in the international capital markets. These debt securities are freely tradeable without the consent of, or even notice to, the sovereign issuer. The investors in these debt securities in the primary market (i.e. at the time of issuance of the debt) typically comprise a range of non-resident financial institutions, pension funds, hedge funds, and asset managers. They hold the securities in their respective investment portfolios so as to receive periodic payments of principal, and interest on the securities. Alternatively, they may choose to trade the securities, either to realise capital gains (when the security has appreciated in value) or to minimise capital losses (when the security has depreciated in value, whether due to a crisis in the relevant country or due to other market factors).

A distinguishing feature of the international debt capital markets is that buyers for sovereign debt securities can (virtually) always be found in the secondary market. Bid and ask prices for these securities are quoted on a variety of platforms, and ordinary trading of sovereign securities is facilitated through major international banks and other financial institutions that provide market-making services. Because the debt securities are typically issued in book-entry form in the international clearing systems, sovereign issuers will typically not know the identity of the holders of their outstanding debt securities. However, in preparation for a bond debt restructuring, the sovereign with the assistance of its financial advisor may resort to the services of an information agent to identify its investor base. This is a key difference in comparison with commercial creditors, with whom the sovereign has a more direct, ongoing relationship (unless creditors resort to silent participations to third-party lenders to reduce their exposure to the borrower).

Specialised investors look for opportunities to buy sovereign debt securities at distressed prices, in anticipation of making a return on their investment when the price of the debt security subsequently improves. These secondary-market investors

play an important role in providing liquidity to market participants in the secondary market. Their behaviour in the context of distressed sovereign restructuring transactions can range from very cooperative to highly uncooperative. It is therefore critical for sovereign borrowers to appreciate the motivations and objectives of secondary-market investors, which may differ substantially from those of primary market participants.

### **Primary and Secondary Markets**

#### **Primary market:**

Investors who participate in the issuance of the debt.

#### **Secondary market:**

Investors who purchase the debt any time after issuance. Certain types of investors specialise in distressed situations and purchase sovereign debt only when prices are low (and yields are high).

# Types Of Financing





## Key Points

*A sovereign has access to different financing options. These include, sovereign loans (concessional and non-concessional), bonds, government-issued credit enhancements, interest rates and currency swaps, Shari'ah-compliant sovereign debt as well as other forms of debt/liabilities.*



*It is important to understand the main features of these instruments and associated relevant documentation and debt incurrence processes.*



*Some specific or more technical aspects need to be looked at more carefully, e.g. the role of the arranger/underwriter, the distinction between legal rights of creditors under loan arrangements and bond trust or fiscal agency structures, price support undertakings, among others.*



*Other specific considerations are the different types of available support (e.g. credit enhancement tools and hedging arrangements) and the nuances of certain alternative debt structures that might be relevant or available to the sovereign.*



*Understanding the contractual provisions, and the ways in which the indebtedness is incurred, are instrumental to comprehending the sovereign's potential commercial and litigation risks.*



## 6 Multilateral and Bilateral Financing

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Multilateral creditors and bilateral official creditors offer myriad instruments, usually linked to a programme or policy. Below are the salient details of these instruments, listed by the type of creditor providing the financing.

### Multilateral Financing

Loans from multilateral lenders often take the form of (a) direct loans, occasionally to the sovereign but more often to a subnational entity (such as a state-owned electric utility), and (b) guarantees to commercial lenders, either international or within the sovereign's market, that then, in turn, lend to the sovereign or a subnational entity. In order to provide credit support for the lending by multilaterals, the sovereign typically provides to the multilateral a guarantee of any loans to a subnational entity, which is often referred to as a counter-guarantee (to be discussed in more detail in Chapter “Secured Lending”).

Multilateral loans are often given within the context of a development or other policy objective. The advantage of such loans is that the financial terms are usually below the market rate that the borrower would receive from commercial lenders, which is known as “concessional” lending. Due to the need for strict oversight and compliance with environmental and social protections, multilateral loans require that the sovereign submit to significant diligence prior to loan issuance.

Multilateral lenders that provide these policy and development-oriented loans usually regard them as non-private law transactions. This is usually reflected in the provisions on governing law and jurisdiction, and in the expectation of the lenders to be given priority in repayment over private sector lenders.

In addition to multilateral loans to support development or achieve policy objectives, the IMF, which is mandated to promote international monetary and financial stability, provides financial assistance to help its member countries address balance of payment problems.

MDBs with both concessional and non-concessional windows have graduation policies from concessional assistance (the AfDB and the World Bank). The main criterion triggering the graduation process is gross national income (GNI) per capita, with the same thresholds applied by the AfDB and the World Bank. Graduation to non-concessional assistance takes place only when the country is assessed as being able to access international financial markets, a creditworthiness assessment that applies for the AfDB and the World Bank, although based on different criteria.

## The African Development Bank Group

### **THE AFRICAN DEVELOPMENT BANK**

The AfDB provides loans on non-concessional terms to borrowers in regional member countries (RMCs), though it does seek to offer financing on more favourable terms than commercial lenders. These loans are categorised as either sovereign-guaranteed loans (SGLs) or non-sovereign-guaranteed loans (NSGLs). SGLs are loans made either (a) to RMCs at the sovereign level or (b) to public sector enterprises, all of which are supported by a counter-guarantee from the sovereign to the AfDB. NSGLs are loans made either (a) to public sector enterprises, without the requirement of a

sovereign guarantee by the host government, or (b) to private sector enterprises, in each case provided that the borrowers meet specific eligibility criteria.

TABLE 1. AfDB Lending Facilities and Instruments

Lending type/facility	Purpose	Duration	Financing terms
Sovereign Guaranteed Loan (SGL)	Loans made to an RMC or public sector enterprise supported by a counter-guarantee from the RMC.	Up to 20 years, with a grace period of up to 5 years.	Commitment fee for policy-based loans; no front-end fees; interest rate terms = base rate + funding margin + lending margin.
Non-Sovereign Guaranteed Loan (NSGL)	Loans made to public and private enterprises that meet specific eligibility criteria, without any form of guarantee from the RMC.	Up to 15 years, with a grace period of up to 5 years.	Commitment fee of 0-1%; front-end fee of 1% of the loan amount; appraisal fee on a case-by-case basis; interest rate terms = base rate + lending margin.
Synthetic Local Currency Loan (SLCL)	Loans to countries to finance in their own currency to reduce foreign exchange risk.	Maturity depends on availability of adequate hedging options for specific local currency loan - up to 20 years for sovereign-guaranteed borrowers, up to 15 years for non-sovereign guaranteed borrowers. Grace period of up to 5 years.	Front-end-fee of up to 1% flat of the loan amount; commitment fee of up to 1% of undisbursed amount; interest rate terms = base rate + funding margin + lending margin; prepayment premium.
Syndicated Loans (A and B loan structures)	To mobilise capital for productive use in viable projects in Africa.	Maturity depends on structure of underlying project and participants' risk appetite. AfDB may accept participations having a different maturity profile from the A-loan grace period, as the final maturity on the participations in the B-loan may be shorter than the grace period and final maturity on the A-loan.	Commitment fee of 0-1% for middle income countries, 0.5%-1% for others; front-end fee of 1% of the loan amount; AfDB may charge appraisal fee on a case-by-case basis; arrangement (praecipium) and syndication fee; loan administration fee; underwriting fee; other fees (e.g. legal and other expenses related to processing of an A- and B-loan syndication).

Lending type/ facility	Purpose	Duration	Financing terms
Partial Credit Guarantees (PCGs) & Partial Risk Guarantees (PRGs)	PCGs can be used to support mobilisation of private funds for project finance, financial intermediation, and policy-based finance. PCGs cover private lenders against the risk of the government, or a government-owned agency, failing to perform its obligations vis-à-vis a private project.	Maturity of up to 20 years for sovereign-guaranteed borrowers; up to 15 years for non-sovereign guaranteed borrowers. Principal repayment period of financing should match the requirements of the project being financed. For structures with bullet repayments, the maximum period is limited to 15 years and an average life of 10 years. Maturity restrictions may apply to certain guarantee structures and currencies.	For an SGL no charges; for NSGL borrowers, 1% of the Bank's possible maximum exposure under guarantee; standby fee charged on undisbursed portion of the underlying loan; between 0 and 1% for NSG borrowers from middle-income countries; between 0.5 and 1% for NSG borrowers from other countries; guarantee fee equal to the lending spread that would have been charged if AfDB had made a direct loan, as a risk premium. Other fees (e.g. legal and other expenses related to initiation, appraisal, and underwriting process of a guarantee; appraisal fees for private sector project); prepayment premium.

## AFRICAN DEVELOPMENT FUND

Unlike the AfDB, the ADF provides funding on a concessional basis for projects and programmes. The following is a summary of terms related to ADF loans and lines of credit.

TABLE 2. African Development Fund

	Maturity	Grace Period	Service Charge	Commitment Fee	Principal Repayment
ADF Loans	Up to 50 years	Up to 10 years	0.75% p.a. on disbursed and outstanding amounts	0.50% p.a. on undisbursed amounts accruing 120 days after loan signature	1% of the principal p.a. from the 11 <sup>th</sup> to the 20 <sup>th</sup> year, 3% of the principal p.a. from the 21 <sup>st</sup> to the 50 <sup>th</sup> year.
ADF Line of Credit	Up to 20 years	Up to 5 years	0.75% p.a. on disbursed and outstanding amounts	0.50% p.a. on undisbursed amounts accruing 120 days after loan signature	N/A

## THE NIGERIAN TRUST FUND

The NTF provides concessional financing to the AfDB's low-income RMCs in order to assist those countries in their development efforts. The NTF's resources can be utilised to provide co-financing with the AfDB and the ADF. The NTF can also

directly fund public and private sector activities. Of note, unlike AfDB resources, NTF resources are allocated to projects, not sovereigns. Proposals related to the poorest ADF countries, countries with small ADF allocations, and fragile states, are particularly encouraged.

The following financial terms apply to NTF long-term concessional loan operations:

- zero interest charges.
- a service charge of 0.75% per annum on outstanding balances.
- a commitment fee of 0.5% per annum on undisbursed commitments.
- a 20-year repayment period with a 7-year grace period (i.e. a 27-year total repayment period).

The following financial terms apply to NTF short-term concessional loan operations:

- zero interest charges.
- a service charge of 0.75% per annum on outstanding balances.
- a commitment fee of 0.5% per annum on undisbursed commitments.
- a 15-year repayment period with a 5-year grace period (i.e. a 20-year total repayment period).

## International Monetary Fund

The IMF's various financing instruments are tailored to address different types of balance of payments problems. Low-income countries (LICs) may borrow on concessional terms through facilities available under the IMF Poverty Reduction and Growth Trust (PRGT); currently at zero interest rates. The Extended Credit Facility is the main tool for providing medium-term support to low-income countries facing protracted balance of payments problems. Historically, the Standby Arrangements have been the primary source of assistance to member countries, seeking to address short-term balance of payments problems for emerging and advanced countries in crisis. Provision of financing under these facilities and instruments is governed by the IMF's legal framework and relevant policies including on access, conditionality, debt sustainability, and financing assurances.

TABLE 3. IMF Financing Facilities and Instruments

Facility	Purpose	Duration	Financing	Repayment
Standby Arrangement (GRA)	Present, prospective, or potential shorter-term balance of payments need.	Up to 3 years, but usually 12-18 months.	Commitment fee, service charge, and lending rate (SDR interest rate plus a margin); surcharge for large loans.	3 ¼ - 5 years.
Extended Fund Facility (GRA)	Balance of payments need arising from serious payments imbalances due to structural impediments, or characterised by slow growth and an inherently weak balance of payments position.	Up to 4 years.	Commitment fee, service charge, and lending rate (SDR interest rate plus a margin); surcharge for large loans.	4 ½ - 10 years.
Flexible Credit Line (GRA)	Present, prospective, or potential balance of payments need (for countries with very strong economic fundamentals and policies).	1 or 2 years.	Commitment fee, service charge, and lending rate (SDR interest rate plus a margin) and surcharges	3 ¼ - 5 years.
Precautionary and Liquidity Line (GRA)	Present, prospective, or potential balance of payments need (for countries with sound economic fundamentals and policies).	6 months (liquidity window), or 1 or 2 years.	Commitment fee, service charge, and lending rate (SDR interest rate plus a margin) and surcharges	3 ¼ - 5 years.
Rapid Financing Instrument (GRA)	Actual and urgent balance of payments need.	Outright purchase		3 ¼ - 5 years.
Extended Credit Facility (PRGT-eligible countries)	Protracted balance of payments need.	3 to 4 years, extendable to 5 years	Zero interest.	10 years, with a grace period of 5 ½ years.
Standby Credit Facility (PRGT-eligible countries)	Present, prospective, or potential balance of payments need.	1 to 2 years	Zero interest; availability fee.	8 years, with a grace period of 4 years.
Rapid Credit Facility (PRGT-eligible countries)	Actual and urgent balance of payments need.	Outright disbursement	Zero interest.	10 years, with a grace period of 5 ½ years.



## World Bank Group

### IBRD

The IBRD offers loans to middle-income countries at interest rates that are lower, and repayment periods that are longer, than the commercial banks (concessional). The lower cost of lending by the IBRD allows borrowers to pursue projects with an economic development benefit that would otherwise be uneconomical.

### IDA

The IDA provides loans and grants for economic development programmes designed on even more favourable concessional terms than the IBRD. IDA lending may feature a low or even zero interest rate, and repayment periods of 30 to 38 years, including a 5- to 10-year grace period. The IDA may also provide grants to countries at risk of debt distress.

TABLE 4. IDA Lending Facilities and Instruments

Form of IDA financial support	Maturity	Grace period	Principal repayments	Acceleration clause
Grants	No repayment	N/A	N/A	N/A
Small Economy loans	40	10	2% for years 11-20, 4% for years 21-40.	Yes
Regular loans	38	6	3.125% for years 7-38.	Yes
Blend loans	30	5	3.3% for years 6-25, 6.8% for years 26-30.	Yes
Guarantees	N/A	N/A	N/A	N/A
Non-Concessional Financing (IDA 18 scale-up facility and transitional support).	Up to 35 years maximum maturity, up to 20 years average maturity.		Flexible.	N/A

# Bilateral Financing

Bilateral debt is government-to-government debt which is negotiated bilaterally between the debtor country and the official creditor. This debt can be either (a) concessional debt, also known as Official Development Assistance (ODA), or (b) non-concessional debt, simply known as “non-ODA” debt.

Non-ODA debt often arises through loans between a government agency or state-owned enterprise (SOE) on the debtor side and, on the creditor side, a commercial partner that benefits from a full or partial guarantee from their specific export credit agency (ECA). Once the guarantee is called, the guaranteed portion of the debt (typically 80%) becomes a claim of the ECA and therefore government-to-government debt.

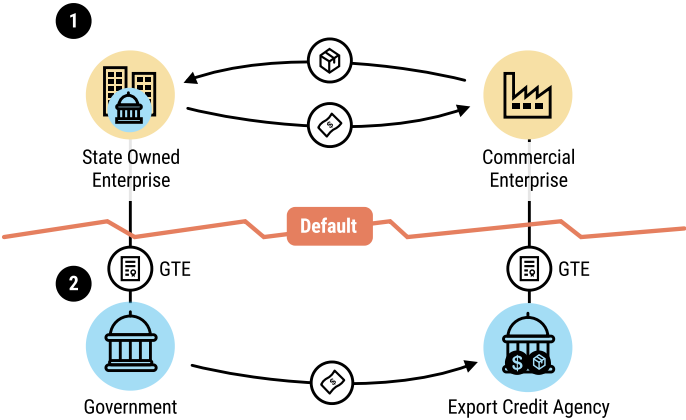


FIG.5. Guaranteed Debt Before and After Default

## Issues Related to Financing from Emerging Bilateral Creditors

Bilateral financing from non-traditional creditors can be similarly structured to financing from traditional creditors. However, experience has shown that although disbursement from these sources is often faster than from other sources that require conditionality, it is often less transparent, subject to high costs, and more secured, and tends to be contracted without due process.

# 7 Sovereign Loans

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Sovereign loans and sovereign bonds (described below) transfer money to the sovereign, creating a debt obligation on the part of the sovereign to repay the amounts so transferred, plus any agreed interest amounts. In the case of loans, the money is transferred, as the word suggests, as a loan by the lender, whereas in the case of bonds, the money is transferred by way of purchase price for a security (bond) issued by the sovereign and sold for that price to investors.

## Types of Loans and Lending Structures

Loans can be classified in numerous ways depending on the purpose for which, and the person to whom, they are provided. In the context of sovereign debt, the most relevant distinction is between direct loans and multiparty loans.

The following is a brief summary of these key types of loans:

## **DIRECT LOANS**

A bilateral loan involves a single lender and typically a single borrower. Although the most common form of lending is bank-to-sovereign, direct loans can also be investment fund-to-government or government-to-government loans.

The structure of direct loans is simpler than that of the multiparty loan structures (see below). Against this advantage, debt managers should consider that syndicated loans usually allow for most decisions to be taken by significant majority of the outstanding loans (which can vary), which provides a lot of flexibility to the borrowing sovereign especially when it comes to the granting of most waivers and the making of most amendments.

A bilateral loan can be tailored for a specific purpose, such as a short-term bridge loan between bond issuances, or long-term financing of an infrastructure project. There are almost always floating rate obligations, which result in fluctuations of payments due. These variations can be mitigated through a hedging strategy (for additional information on hedging strategies see Chapter “Swaps”).

## **MULTI-PARTY LOANS**

Multi-party loans are loans between a borrower and two or more lending entities. All such loans are “syndicated loans” in form and content of provisions.

Market participants often make the distinction between “syndicated loans” and “club loans”, depending on size and marketing strategy. “Syndicated loans” are likely to have a larger number of lenders than “club loans” with many of these lenders interested in the yield of the loan and without necessarily an established relationship with the sovereign lender. “Club loans”, on the other hand, tend to have a smaller number of lenders and all of them tend to have a historic or other close relationship with the sovereign lender. This market distinction will be explained below.

## **SYNDICATED LOANS**

Syndicated loans are loans where one or more commercial banks, acting as arrangers (the lender or lenders responsible for “arranging” or putting together the syndicate are known as the “lead bank”, “lead lender”, or “underwriter”) and lenders, negotiate

with a borrower (a sovereign, subnational, or SOE) the terms and conditions of a syndicated loan, on the basis of a partially or wholly underwritten transaction. Such syndicated loans may or may not involve guarantees.

Syndicated loans are slightly more complex than direct loans, given that an initial arranging lender will establish the key terms of the loan (e.g. maturity, principal amount, and interest rate). These key loan terms can only be amended with the consent of all syndicate lenders. However, amendments of all other terms, and indeed, waivers (even waivers of events of default), can usually be made with the consent of significant majority of outstanding loans (which can vary).

Like direct loans, syndicated loans can also be tailored for a specific purpose.

The role of the arranger(s) is to negotiate with the borrower the amount, terms and conditions (including governing law), and the use of funds (project-related financing or financing of budget deficit, etc). Terms and conditions will reflect the arranger's assessment both of the quality of the borrower's credit risk and of the prevailing market conditions.

The arranger(s) will conduct a brief due diligence on the borrower and prepare an information memorandum to market the loan among potential syndicate participants.

All syndicate members will agree the terms of the loan and appoint an “agent” (normally one of the arrangers) who will carry out all of the syndicate's administrative functions. Payments to and from the borrower will also be administered by and, almost always, flow through the agent.

Even though lenders act as an organised group, the obligations of a lender in a syndicated loan are several (i.e. no lender assumes the obligation of another one). This means, for instance, that if a lender fails to advance its portion of the agreed total loan, the remaining lenders will not have to advance that portion. At the same time, there is a degree of solidarity between syndicate lenders as they agree to share recoveries between themselves in proportion to their respective loan participations.

## **CLUB LOANS**

A club loan (also known as a consortium loan) is a syndicated loan in form. As noted above, “club loans” tend to have a smaller number of lenders and all of them tend to

have an historic or other close relationship with the sovereign lender. All these relationship lenders arrange the loan together and one of them assumes the agency functions of their syndicated credit.

## **SUB-PARTICIPATIONS**

Lenders under bilateral commercial loans or syndicated loans have the right to transfer their participations to other lenders. The transfer to another lender can be done either (a) by bringing in that other lender as a participant in the loan with a direct contractual relationship with the borrower or (b) in a manner where that other lender shares in the funding and/or risk of all or part of the loan of the transferring lender without a direct contractual relationship with the borrower. The latter method is known as “sub-participation”, and the lender to whom the transferring lender transfers the funding and/or risk a “sub-participant” .

The structure of sub-participations can be complex. They include (a) “funded participations” where the sub-participant makes a deposit with the transferring lender and (b) “risk participations” where the sub-participant guarantees to the transferring bank a percentage of the transferring lender’s losses from its direct loan. Sub-participations can allow the funded or risk participants to vote in the decisions of the syndicated loan or they may disenfranchise them.

Sub-participations add flexibility and complexity to lending structures. Even when the sub-participants are disenfranchised, they can change the balance of interest of the parties. Debt managers need to understand them well if they are to allow them in their lending structures.

## **Loan Facilities**

Loans may be structured in a manner that allows borrowers greater flexibility to access funds over a long term under specified conditions. These more structured loans offer not just simple loans, but a wider and more complex range of “facilities” and are referred as such.

## TYPES OF FACILITIES

Facilities can take many forms:

1. Revolving facilities that allow a borrower to draw, repay and then redraw again.
2. Term facilities that allow the borrower to borrow specific sums for a specified period of time (the “term”).
3. Standby facilities that keep the funds in reserve and allow the borrower to withdraw upon satisfaction of pre-determined conditions.
4. Letters of credit/guarantee facilities that allow the sovereign extending the credit under the facility to issue letters of credit/guarantees to third parties, with the sovereign retaining an obligation to repay the facility lender if the letter of credit/guarantee is called by the third party.

Loan facilities can also allow drawings in multiple currencies, although it is likely that most debt managers will wish to use the spot and swap markets for managing their currency commitments.

## SECURED VS UNSECURED FACILITIES

Lending facilities can be either secured or unsecured. Given the nature of the sovereign borrower, most sovereign loans are unsecured.

The purpose of secured lending is to give the lender access to the pledged security in case the borrower should fail to meet its obligations under the loan (e.g. in the case of a default). For more information, refer to the Chapter “Secured Lending”.

# Loan Documentation

The loan document, called either the “loan agreement”, “credit agreement” or “facility agreement”, sets out the contractual terms and conditions under which a lender agrees to lend money to a borrower.



## Principal Terms & Conditions of a Loan Agreement

The key provisions of loan agreements include:

**Parties:** the names of the parties.

**Facility amounts:** The amounts the lenders are committing to lend.

**Availability period:** The period during which the borrower can ask the lenders to advance the loan.

**Conditions precedent:** The conditions which must be satisfied prior to the loan being advanced to the borrower.

**Purpose of loan:** The purpose for which the borrowed funds will be used.

**Drawing mechanics:** The mechanics under which loans must be requested and advanced (times of request and payment, minimum amounts requested etc).

**Repayment terms:** The date(s) on which the loan is to be repaid ("maturity date"), and if in instalments, the amounts of such "amortisation" instalments.

**Early voluntary prepayment:** The conditions and mechanics under which the borrower can repay all or part of the loan ahead of its maturity date. Early prepayments may carry the payment of broken funding costs or fees to the lenders.

**Early mandatory prepayment:** The events whose occurrence will entitle the lenders to require the borrower to prepay all or part of the loan ahead of its maturity date. These events are "no fault" early termination provisions and both they and their interplay with the borrower's remaining contractual terms in other debt instruments must be well understood.

**Interest:** Calculation of interest (almost always on basis of floating interest base rate reflecting the lenders' cost of funds (commonly by reference to an accepted base rate such as LIBOR, EURIBOR, U.S. Federal Funds Rate), plus a margin, interest periods (typically one, three, and six months) and default interest. Interest is calculated either on a 360-day year basis (usually for Euro or US dollar financing) or a 365-day year basis (for Sterling financing).

**Increased costs provision:** This provision is typically included in a loan agreement as a type of “risk allocation provision” to protect the lender in the case of an increase in a cost of lending caused, for example, by a regulatory change.

**Representations and warranties given by borrower:** These are the statements made by the borrower concerning its legal status, its authorisation, its financial condition, its other debt levels, its disputes, as well as other factual matters which are of credit interest to the lenders. Incorrect representations or breaches of warranties entitle the lender to terminate the loan contract and seek repayment and, if appropriate, damages.

**Undertakings/Covenants:** Loan agreements include three types of undertakings/covenants – affirmative, negative, and financial:

1. An affirmative undertaking/covenant is a promise **to do** something under the loan agreement. An example is the promise to obtain and maintain all authorisations required for the validity of the loan agreement.
2. A negative undertaking/covenant is a promise **not to do** something. An example is the “negative pledge”, a promise not to create or allow security (or equivalent) over the borrower's assets in favour of third-party creditors. Other negative covenants (which however are unlikely to be relevant in the context of sovereign loans) are restrictions on the payment of dividends/distributions, the disposal of assets, the incurrence of financial indebtedness, the granting of security over assets, etc.
3. Financial covenants are not common in sovereign loans. When present in loan agreements, financial covenants seek to ensure that the borrower is maintaining or attaining certain financial targets.

**Sovereign Immunity:** Waivers of sovereign immunity include waiver of the immunity from suit (litigation or arbitration) and waiver of immunity from enforcement of attachment/foreign awards over the sovereign's commercial assets.

**Governing Law:** This is the law governing the interpretation of the loan agreement. International lenders will usually ask for English or New York law.

**Jurisdiction:** This specifies the type and place of the forum where disputes will be adjudicated. They usually follow the governing law, and so will be English or New

York courts, or arbitration tribunals, especially those in large financial centres, based upon impartiality and market practice considerations.

**Events of default:** These are the events whose occurrence entitle the lenders to seek early repayment, cancel any undrawn commitments. The most common events of default are set out in Box X. Like the other provisions of the loan agreement, they will need to be considered carefully, especially the cross default/acceleration clause which inter-connects all of the sovereign's debt. In particular, the definition of the perimeter of the debt which cross-defaults/accelerates a loan (or indeed any other debt), will require careful attention.

## Sovereign (or “state”) immunity

Sovereign (or more correctly “state”) immunity is an international law doctrine according to which a sovereign cannot be subjected without its approval to the jurisdiction of another sovereign. It covers immunity from (a) jurisdiction to hear disputes, (b) jurisdiction to recognise foreign judgments/awards and (c) enforcement and execution of judgments/awards. As the doctrine is one of international law, the manner in which it is applied will depend on the manner each individual sovereign country and its courts have chosen to apply it. Some countries apply the doctrine in an absolute way without exceptions. Some other countries (including the United States of America and England) apply the doctrine in a restrictive way and will not, in most circumstances, allow immunity to protect another sovereign for its commercial acts or in respect of its commercial assets.

In the context of raising debt, sovereign borrowers will almost always be asked to waive their rights to invoke any type of immunity in respect of proceedings relating to their debt obligations. The scope of this waiver can be negotiated, within limits.

Sovereign (or “state”) immunity is a highly technical and complex legal topic and potentially involves a number of different jurisdictions. Even if sovereign immunity is not waived, enforcement may still be possible if the competent courts determine that the assets are in fact the property of the sovereign, but are held through an intermediary.

This is a difficult area of the law. Seeking proper legal advice at an early stage is of the essence. Any early missteps can have serious adverse consequences.

## Sanctions, anti-corruption, anti-bribery anti-money laundering and anti-terrorism laws

No debt raising is possible without consideration of a host of legal regimes on sanctions, anti-corruption, anti-bribery anti-money laundering and anti-terrorism.

Financial and trade sanctions are used by international organisations and government bodies to discourage regimes or individuals from acting in ways generally condemned by the international community or individual nations by means of prohibiting certain transactions. Sanctions may take the form of targeted financial restrictions, such as asset freezing or "blocking" regimes, or more comprehensive export/import controls on goods, technology and services such as embargoes on commercial trade activity and transport, or all of the above. Sanctions can either target specified individuals and entities, or may target industry sectors or entire countries.

Sanctions law is distinct from anti-corruption, anti-bribery, anti-money laundering and anti-terrorism laws. These laws target categories of unlawful behaviour by prescribing specifically acts of corruption, bribery, money-laundering and terrorism each as defined in the relevant laws of each of the international organisations and government bodies promulgating these laws.

The way all these laws are enforced are through penalties, not only on the persons engaging in the proscribed activity, but also on a number of others who are considered facilitators, enablers or intermediaries. International institutions providing or arranging finance to sovereigns will almost always be subject to a number of such legal regimes and will therefore want to ensure that they do not breach any of their provisions. They will do this through their own diligence investigations and through reliance on the sovereign's representations and on-going undertakings. Their focus will not be solely on the specific transaction as on the laws of the sovereign, the way these laws are implemented and the on-going commitment of the sovereign to participate in efforts to eliminate any such unlawful activity. If these institutions are not satisfied, they are unlikely to assist the sovereign in the raising of its finance. This in turn makes the overall efforts of the debt manager to

raise and manage the finances of the sovereign more difficult and probably more expensive.

Sovereigns should adopt long-term policies on these matters and should consult at an early stage their financial and legal advisors, bearing in mind of course that international advisors will also be themselves subject to the same legal restrictions imposed by these legal regimes.

**Events of default usually include the following:**

1. Non-payment (of principal or interest) subject to a short grace period to remedy the non-payment.
2. Breach of borrower's other obligations under the loan contract, subject to cure periods where the breach can be remedied.
3. Misrepresentation or breach of warranty.
4. Cross-default (an event of default occurring in another debt instrument) or cross-acceleration (an acceleration or enforcement by creditors under another debt instrument), in either case subject to a certain threshold and also in respect of specified debt instruments.
5. Overall payment moratorium.
6. Borrower's repudiation of the loan.
7. Judgement against the borrower for the payment of an amount in excess of an agreed threshold.
8. Illegality (the adoption of any applicable law, rule or regulation which would make it unlawful to comply with the obligations agreed under the loan).
9. Loss of IMF membership or ineligibility to access IMF financial assistance.

In addition to the loan agreement itself, other agreements might be entered into in respect of the loan, such as a security agreement (in the case of secured lending facility), a guarantee agreement, or an intercreditor agreement (to determine how to deal with competing interests of multiple lenders vis-a-vis one borrower).

## Syndicated Loan Market Practices

Although there is no standard form of contract used for all syndicated loans, there are market guidelines and practices which are widely used. In Europe, the Loan Market Association (LMA), for example, publishes standard form loan agreements and guidance notes on syndicated loan terms.

As the LMA states, the organisation “... has as its key objective improving liquidity, efficiency and transparency in the primary and secondary syndicated loan markets in Europe, the Middle East and Africa. By establishing sound, widely accepted market practice, the LMA seeks to promote the syndicated loan as one of the key debt products available to borrowers across the region.” (Loan Market Association 2018)

## 8 Sovereign Bonds

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Although both loans and bonds result in “borrowings” by the sovereign, there are important formal differences between bonds and loans. Unlike loans, where the money is provided, as the word suggests, as a “loan” by the lender, borrowing under bonds arises from the payment of purchase money by the investors to the sovereign issuer of the bond security. There are many other differences of form, documentation, issuance, and management. This chapter provides some initial guidance on the most important practical differences.

Bonds are debt instruments, evidencing the payment obligation owed by the issuer of the bonds to the holders.

Bonds offer sovereign borrowers an alternative financing option to loans, and the possibility of reaching a broader universe of prospective investors. Bonds are tradeable debt securities, often listed on one or more domestic or international stock exchange. Investors in bonds provide financing to the issuer for a fixed period of time. In return, investors expect to receive an interest payment, usually calculated by reference to a fixed “coupon” (a specified percentage) of the face value of the amount of the bond. Repayment of the principal of the bond occurs either upon maturity in a single payment (also known as “bullet” payment) or pursuant to an agreed amortisation schedule.

When bonds are issued, they can be privately or publicly offered to investors. If they are offered to a limited group of investors, this is referred to as a “private placement”. If they are publicly offered, this is referred to as a “primary market” issue. Once the bonds have been issued and allocated to investors, any subsequent trading will take place in what is known as the “secondary market”. Payment clearance and settlement of secondary market trading is completed via the international clearing systems

## Types of Bonds

The term “bonds” is colloquially used to refer to different tradeable debt instruments – which creates confusion when people are confronted with different terminology (short term paper, Eurobonds, medium-term notes, etc.). This situation is made more problematic by the fact that the terminology also varies from jurisdiction to jurisdiction, based on how these instruments are regulated. Generally speaking, however, the classification would be as follows:

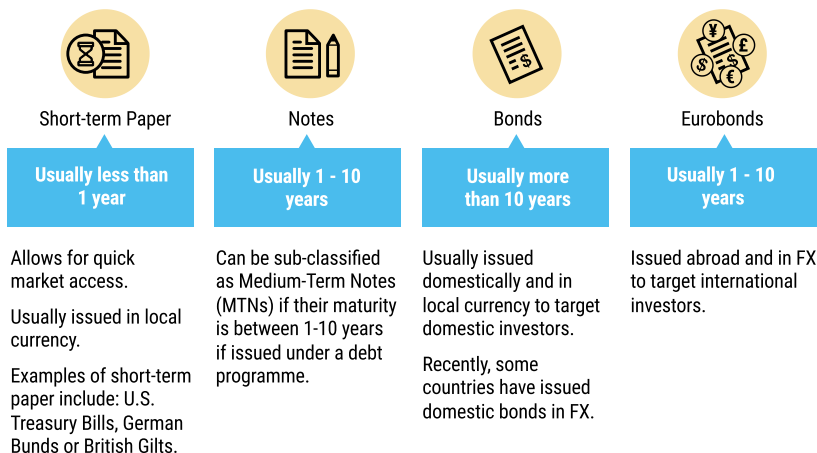


FIG.6. Types of bonds



## A Note on Eurobonds

“Eurobonds” were originally defined as bonds which were issued outside the domestic market of the currency in which they were denominated. The use of the term has broadened to encompass international issuances generally, and so its current definition is that of an issuance in a currency other than that of the issuer.

The term “bond” has many meanings, however the following are considered “classic” bond offerings as they are the most common in the market currently.

## New Bond Offerings: Financial Innovation

Bond structures continue to evolve to allow issuers to reach an even more diverse investor universe. Examples of these structures include:

**Commodity-backed bonds:** Bonds whose value is directly related to the price of a specified commodity.

**Inflation-linked bonds:** Bonds which will protect the investors against the risk of greater-than-predicted inflation eroding their investment returns.

**Project bonds:** Bonds whose proceeds are used to finance (or more often to refinance) a specific infrastructure project. Repayment of these bonds comes from the revenues generated by this project.

**Green (climate) and Blue (water) bonds:** These bonds will be earmarked for climate/environmental and marine/ocean-based projects respectively.

### Green Bonds:

A bond whose proceeds are earmarked solely for environmental projects. Sometimes the same category includes “climate bonds” whose proceeds are earmarked solely for investments in emission reduction or climate change adaptation. A green (or climate) bond is typically linked to the financed asset or project but is also backed by the issuer’s full faith and credit. Some green or climate bonds can be highly structured, especially if they benefit from the credit support of

a multilateral organisation. In developing economies, green bonds are used to finance critical projects, including renewable energy, urban mass transit systems, water distribution, but also more targeted “green” projects such as forest regeneration.

## Domestic vs. International Capital Markets

The domestic capital market refers to the local market of the sovereign issuer. Bonds issued in the domestic market are usually denominated in the local currency, although in some rare cases these domestic bonds can be issued in foreign currency.

The international capital market broadly refers to everything beyond the domestic market, and is widely used to describe all international investors and the market that governs them.

## Bond Pricing

There are several aspects that have a direct impact on the pricing of bonds. Some of the most relevant ones include:

### Credit Risk

The price of a bond in both the primary and secondary market depends on the perceived credit risk of the issuer. If the market believes that the issuer will have the capacity and willingness to pay its obligations in full and on time over the term of the bond, the market price of the bond will reflect this confidence. Conversely, if the market believes that the issuer may have difficulty (for whatever reason) meeting its obligations over the term of the bond, the market will demand a higher return for that risk. Perceptions of credit risk will vary over the term of the bond. Such changes in perception, together with market movements in the base rate of the currency of the bond, will affect the “yield” of the bond, through changes in the trading price of the bond over or below its face (par) value.

## Maturity

In addition to the perceived credit risk of the issuer, as described above, the maturity of the bond, i.e. the duration of time before the bond issuer must repay the principal, is also significant. Investors demand a higher return if they are holding the bond over a longer period of time, because they will be exposed to a potential risk for longer. This is not necessarily the case. In pre-crisis periods, the yield on the shorter maturities may be higher than on the longer ones. An inverted yield curve indicates debt repayment difficulties in the near future.

## Interest Rate

The rate for calculating the interest paid to bondholders will be determined at issuance based on the perceived credit risk of the issuer, the prevailing bank lending rate, and the expected inflation at the time of the issuance.

The interest rate on a bond can be fixed, floating or indexed.

The nominal interest rate paid on the nominal amount of a bond is called its “coupon”. It has to be distinguished from the effective interest rate on the bond, called “yield”, which is calculated by reference to the trading price of the bond (at any time above or below par), its maturity, and its coupon. For example, if a bond has a USD 100 principal value, remaining maturity of one year, and a 3% coupon, but is currently trading at a price of USD 90, then the current yield is 3.33% (coupon/current price, which is higher than the coupon rate). As a result, even though the bond has a fixed coupon rate, the current yield will fluctuate as the bond price changes over time.

Some bonds are issued without any coupon (called zero coupon bonds). They are issued at a discount to their face value, to compensate for the lack of interest payments. For example, a short term paper with a nine month maturity (e.g. a US Treasury Bill) that includes a promise to repay the bill holder USD 1,000 in nine months, may be sold at a price of USD 975, which results in an effective return rate of 2.5% if the bill is held until maturity.

## A NOTE ON THE PREVAILING BANK LENDING RATE

As investors are more easily able to move their financial capital across borders within an increasingly globalised capital market, the impact of bank lending rates can be global in its scope, such that bond prices in one country will fall as bank rates rise in another country.

## Bond Prices Over Time

As bond prices change continually thanks to their continuous trading on secondary markets, bond price trends can vary over time, depending on shifting investor perceptions of issuer creditworthiness, competitive interest rates, and competing investments. In extreme cases, bond price volatility can be significant. For example, a bond that was originally issued with a purchase price of USD 80 may end up being discounted as low as USD 0.05 if investors believe that there is virtually no likelihood of repayment. The reverse is also true, as a bond price may rise if investors believe that the likelihood of repayment has increased since the original issuance of the bond.

It is important for sovereign debt managers to track the pricing of their outstanding bonds, since that pricing is a strong indicator of investor sentiment and can act as a warning signal for financial crisis or market swings. Similarly, improvements in bond prices may signal investor appetite for the sovereign's bonds, such that the sovereign may wish to issue additional bonds to capitalise on that sentiment.

## Unique Contract Clauses

Many of the contractual provisions of commercial loans are also common to bonds (i.e. payment, negative pledge, events of default, sovereign immunity, and governing law and jurisdiction). However, below are two clauses in bond contracts that have been the subject of much recent debate and commentary in the debt capital markets.

## Pari passu

The *parri passu* clause is a representation and an undertaking that holders of the bond rank, and will at all times rank equally (*pari passu*, a Latin phrase meaning “on equal footing”) with holders of other unsecured and unsubordinated debt obligations of the issuer. This clause was at the heart of long and controversial litigation before the New York courts centered on contractual ambiguity over rateable payments. The dispute was ultimately resolved, and most of the legal concerns surrounding the interpretation and application of the clause (as written in the Argentine bonds) have since been resolved. In order to avoid any future debate and confusion, the International Capital Markets Association (ICMA) has prepared a draft template of this clause that has removed ambiguities by explicitly excluding rateable payments and become the market standard. Debt managers are advised to follow the ICMA precedent for this clause.

## Collective Action Clauses

The tradeable nature of bonds means that any single bond series has a disparate and anonymous investor community. The sovereign knows the lenders in a loan agreement, whereas it does not know the identity of the owners of its publicly-issued debt securities. This means that the interaction of the sovereign and its creditors to agree amendments to the terms and conditions of the bonds has to be done in a more formal manner, as prescribed in the terms and conditions themselves.

At the core of the amendment mechanism of bonds are the collective action clauses (CACs). These provisions allow the sovereign issuer to propose changes to its bondholders, who are then able to vote for them. Changes relating to any of the terms and conditions can become effective and bind all the bondholders if accepted by the contractually-defined bondholder majority.

CACs have existed in English-law-governed contracts since the middle of the 19th century. For historical reasons they have not been common in New-York-law-governed bonds until fairly recently. The litigation in New York which followed the Argentine default provided the impetus for further innovation in the design of CACs. The latest such CACs, as set out in ICMA's draft template, offers a menu of voting procedures, including allowing the sovereign issuer to ask all its bondholders (or any

group among them) to vote on changes to their bonds as a whole, regardless of each bondholder's individual series. The new CACs make it easier to effect global amendments to a sovereign's bonds, including amendments on the most challenging of matters, such as maturity date, level of coupon, and nominal amount repaid.

# 9 Bond Issuance

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There is a well-established process for the issuance of sovereign bonds. The structure, legal documentation, target investor market, nature of the parties involved, and market conditions can all influence the issuance process. The duration of the bond issuance process is also variable, and will often depend on whether this is the first bond offering (known as a “debt” or “inaugural” issue for the issuer (known as a “debut” issue) or is a frequent issue or involves sales to investors in the United States or any other jurisdiction which has specialised securities laws. A debut offering may require several months from start to finish, while a follow-on offering by a repeat bond issuer can be accomplished in a matter of several weeks. Offerings which require more detailed disclosure on the part of the sovereign issuer may require longer periods.

This chapter introduces the key parties involved in a bond issuance, and describes their roles. This is followed by a description of the main documentation required in a bond issuance. This in turn informs the bond issuance process, as references are made to the different parties and the required documents during the different steps of the process.

## Parties Involved in a Bond Issuance

The key parties involved in a bond issuance, and their roles, are summarised in the following tables:

TABLE 5. Parties Involved

Arranger	Manager (s)	Financial advisor	Guarantor	Registrar
Develops the bond issue structure, size, and terms, based on the issuer's needs. Organises investor roadshow and investor presentation based on prospectus. Appoints legal counsel to commence draft of underlying legal documentation.	Works with the arranger in preparing the bond issue. Undertakes initial purchase and placement of bonds.	Independent advisor of the issuer. Advises on all aspects of the bond issue process including the selection of arrangers/book runners, managers, place of bond listing, etc.	A third party who guarantees totally or partially the payment of coupons and repayment of principal.	Holds the register of holders of the bonds.

Listing agent	Rating agency	Transfer and Paying agent	Calculation agent	Legal Counsel	Process agent
Only relevant for bonds listed on a stock exchange. Advises the issuer on the requirements and procedure for listing the bonds. Liaises with stock exchange on submission of all necessary documentation for listing the bonds.	Assesses the creditworthiness of the issuer and assigns a rating to its bonds. Usually: Fitch, Moody's or Standard & Poor's.	Only relevant for registered bonds. A third party that facilitates change in ownership when bonds are transferred, and bond repayments, and coupon payments	A third-party agent responsible for making required calculations for determinations under the bonds, e.g. to calculate an interest rate.	Each of the sovereign and the arranger appoint its own legal counsel to draft and settle legal documentation, conduct due diligence, prepare the prospectus, and issue legal opinions.	It is required to appoint a process agent to act on behalf of the issuer when a bond is governed by English law, to allow service of process in England in the case of dispute.

## Critical Documents in a Bond Issuance

A bond issuance requires a substantial amount of preparation. A number of documents are required for a bond issuance, whether offered through a widely marketed public offering or through a private placement. The main documents involved in a bond issuance are summarised below, together with a brief explanation of their purpose:



TABLE 6. Main Documents

Mandate letter	Subscription agreement	Fiscal agency agreement or trust deed	Preliminary Prospectus
The issuer mandates an investment bank to arrange the issuance of debt.	Document that states the terms that govern the manager-issuer relationship. Establishes the conditions under which the manager would buy or procure investors to buy the issuer's bonds.	The fiscal agent represents the interests of the issuer and aims to fulfil the payments of the issued bonds, maintains records of payments, etc. The trust deed regulates the relationship between the trustee (usually a financial institution) and the issuer. The trustee represents and acts in the best interests of the bondholders.	This is the finalised advanced version of the Prospectus produced by the sovereign issuer, providing information about the issuance to give to investors used for the roadshow. Only the pricing information is still subject to confirmation.

Final Prospectus	Terms and conditions	Global bond	Legal opinions	Interest hedging agreement	Process agent agreement
The final offering document for the bond issue, submitted for the bonds to be listed. Customarily the only difference with the Preliminary Prospectus is the inclusion of the pricing information.	The terms and conditions are set out in the Prospectus and contain the key commercial terms between the issuer and the bondholders (negative pledge/events of default/ governing law/ sovereign immunity etc.)	The bond representing the entire amount of the issuance. Includes the main features of the bond issuance.	It is a usual requirement to obtain legal comfort that: (a) the sovereign issuer has the capacity and power to issue the bonds and that they are a legally binding obligation of the issuer; and (b) the English law bond agreements are legal, valid and binding.	The issuer may enter into an interest or cross-currency swap to mitigate the interest or currency risks of the bond.	Agreement where the issuer appoints someone to act as process agent in England (the governing law of the bonds). In the case of sovereigns, it is common to appoint the Ambassador or the Commercial attaché in the jurisdiction.

## Bond Issuance

The following is a description of the typical five phases of a bond issuance: (1) pre-launch; (2) marketing; (3) pricing; (4) closing; and (5) post-issuance.

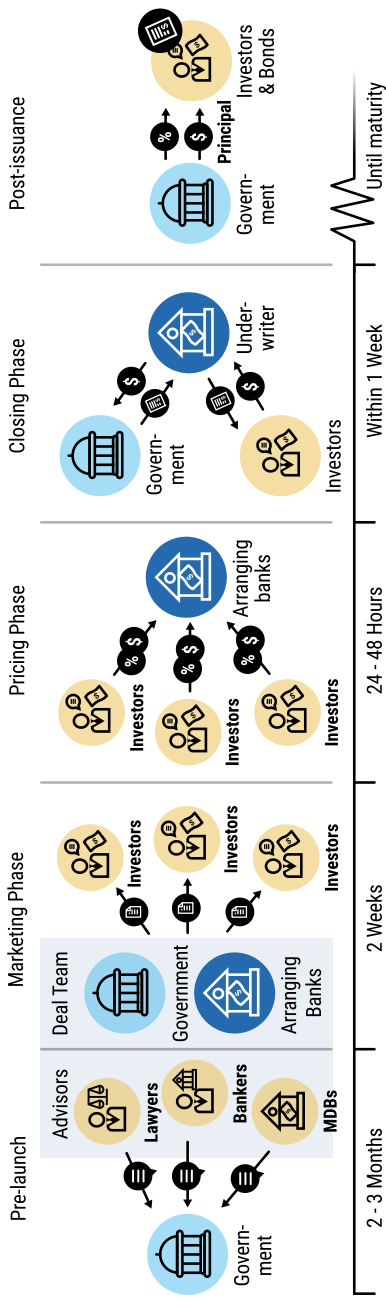


FIG.7. Five phases of bond issuance

## Pre-launch

The sovereign is usually well advised to appoint a financial advisor (independent of the role of lead manager/arranger) to work with it on all preparatory aspects of an international bond issuance. The work of the financial advisor involves advice on the selection of bookrunners, arrangers and managers. At the appropriate time, the sovereign will also need to appoint legal advisors to assist with the documentation, disclosure and bond issuance process.

The pre-launch phase starts when the sovereign bond issuer instructs, by means of a mandate letter, one or more lead manager(s)/arranger(s) to underwrite a new issue of bonds. The issuer will also select a paying agent and a trustee (or fiscal agent) for the issuance. The lead manager/arranger will appoint lawyers to act for them, will coordinate with the stock exchange where the bonds will be listed (if relevant), and will liaise with the sovereign issuer and its legal advisors to prepare the bond documents (including the prospectus/offering circular). At this point, the entire issuance team is working intensively with rating agencies, financial advisors, and others to settle all legal documentation to allow for the announcement of the deal to the market.

Where the sovereign is seeking some form of credit enhancement from a guarantor, such as a multilateral development bank, to improve the risk profile of the bond, the sovereign issuer will also need to involve the guarantor (and its advisors) at a very early stage.

## Marketing Phase

Once the bond documents are essentially finalised and in agreed form, the lead manager/arranger announces to the market that they have been mandated to arrange a series of meetings between the issuer and the investors usually in key investment centres (often described as a “roadshow”). The “preliminary prospectus” is used for these roadshow meetings with investors. A roadshow usually lasts for 4 or 5 days.

## Pricing Phase

The pricing phase immediately follows the roadshow where the lead manager/arranger invites investors to indicate the commercial terms (coupon, issue price, yield and maturity) and amount of bonds that they would be prepared to purchase. Based on this feedback, the lead manager/arranger builds a “book” of orders for presentation to the issuer. The issuer then determines the size, pricing and maturity of the bond offering based on this investor feedback, and the lead manager/arranger communicates this decision to the investors that have indicated interest in the bonds.

## Closing Phase

After pricing, the lead manager/arranger and the issuer sign a subscription agreement that legally binds the managers to subscribe for the offered bonds on the date of financial closing (which normally occurs five days after pricing). Based on the book of orders, allocation of the bonds are made to investors by the lead manager/arranger, and investors are asked to enter into a binding agreement on the amount of bonds they are willing to buy on the closing date. At closing, all parties involved in the issuance execute their respective agreements and the bonds are formally issued and delivered by the sovereign. The listing of the bonds on the selected securities exchange occurs, and the rating is confirmed by the chosen credit rating agency. The issuer receives the cash proceeds of the bond offering from the lead manager/arranger (who has in the interim collected the payment price from investors to whom bonds were allocated), and investors have bonds credited to their securities accounts in the international clearing systems. Closing is deemed to have occurred.

## Post-issuance Phase

In the post-issuance phase, the issuer pays the bondholders the periodic interest and principal due under the contractual terms of the bonds until maturity. This is done through the paying agent.

## Special Considerations in the Issuing Process

This section provides a brief overview of certain specific aspects of the bond issuance process that require special consideration. These are the preparation of sovereign disclosure, due diligence, the listing process, the rating requirements, and the underwriting process.

### **SOVEREIGN DISCLOSURE**

When a sovereign accesses the international debt capital markets, it must prepare and include in the prospectus a description of the country to enable potential investors to make an informed investment decision. This description will cover a variety of matters, including an overview of the political system, a description of the economy and its key sectors, an overview of monetary policy and the banking system, data on balance of payments, budgetary information and data on public debt. There will also be a section describing material risk factors that should be borne in mind by market investors when considering an investment.

The preparation of the sovereign disclosure will be time consuming and require gathering of information from many different institutions within the government. The coordination of the information gathering process is usually handled by the ministry of finance, but the selected legal advisor for the issuer normally “holds the pen” when drafting the disclosure included in the prospectus, possibly assisted by the financial advisor. Usually, multiple iterations of the sovereign disclosure will be prepared before it is in final form. These iterations will reflect, among other things, comments received from the banks acting as managers of the offering process. The final scope and content of the sovereign disclosure will be subject to the approval of the listing authorities before the bond offering is completed.

### **DUE DILIGENCE**

The banks selected to act as managers of the offering will be exposed to legal and reputational risks in connection with the offering and sale of the bonds to investors. Should there be material errors or omissions of material information in the prospectus, the managers may have liability toward investors who purchase bonds in the market. To minimise these risks, the managers will usually insist upon a process

for verifying the factual information in the prospectus and ensuring that all material factors have been properly addressed. This will generally include a “due diligence” meeting, which can take a few hours to as much as a day, where the managers and their legal counsel have an opportunity to ask questions of representatives of the government. This process can be surprising for issuers who have not previously accessed the debt capital markets, but is normal and required. The financial and legal advisors of the issuer will also attend the due diligence meeting and will be available to answer questions the sovereign may have about the process.

## **LISTING OF BONDS**

To obtain optimal terms and pricing, issuers typically seek to target as large a universe of prospective investors as possible. As part of maximising the market for a bond offering, most international sovereign bonds are listed on a securities exchange. The listing procedure of the exchange, which normally involves obtaining the approval of the content and substance of the prospectus from a regulatory authority in the jurisdiction where the exchange is located, may also provide an extra sense of security to investors. The most common stock exchanges targeted in these issuances are London, Dublin, Luxembourg, New York and Tokyo, but of course this will depend on the targeted investors.

Needless to say, the listing process takes time, which presents challenges for sovereigns seeking to capitalise on windows of opportunity in a fast-paced market. A common practice to shorten listing time is to proceed with a “shelf registration” that allows splitting the issuance into multiple issuances. The sovereign can forecast longer-term financing needs and do a shelf registration for an amount higher than its actual debt-raising needs (e.g. double or triple the amount to be issued) and then, dependent upon future needs, proceed to issue a new series of bonds without the burdensome requirements of a full issuance registration.

Another practice to avoid listing times is to proceed with a private placement. In a private placement, the bonds being issued are allocated through a private offering to a single or a small number of investors (i.e. not through a public offering). This placement takes place outside of a securities exchange, although it may still require significant structuring and diligence to generate investor confidence in the bonds.

## RATING OF BONDS

As part of the issuance process, bonds are usually rated by international credit rating agencies (CRAs) that are independent companies acting upon request of the issuer to assess the credit-worthiness of the financial instrument. These independent companies seek to reduce “information asymmetry” by analysing the probability of default for the bonds issued by a sovereign. There are three CRAs dominating the international rating market: Fitch Ratings; Moody’s Investors Service Limited; and Standard & Poor’s Rating Services.

## Bond Underwriting

When a bond is being issued in the primary market, the sovereign issuer will employ the services of one or more investment banks to act as lead manager(s) or arranger(s) of the offering. The lead manager/arranger plays a key role in coordinating the issuance, marketing, and book building process, and will assume certain underwriting risks in connection with the initial placement. Specifically, it will (1) assist the issuer in determining the financial terms and timing of the proposed issuance; (2) use its best efforts to distribute the bonds to investors in the selected markets, and (3) agree in certain circumstances to buy such bonds from the issuer in case the distribution is not successful in whole or in part.

In general terms, underwriting refers to the process whereby the lead manager/arranger secures commitments from investors to purchase bonds of the issuer in connection with a primary offering. Different underwriting structures may be agreed with the underwriting banks, with different commissions paid to the banks involved to compensate them for the magnitude of commercial risks they are assuming. In a nutshell, underwriting involves:

Level 1: Using best efforts to place the bonds but with no commitment to purchase bonds that are not taken up by third party investors, which offers minimal risk to the underwriter and hence lowest underwriting commissions.

Level 2: Subscribing for any unsold bonds in the primary offering, which offers a greater degree of risk to the underwriter, who may end up with a sizeable amount of debt on its books depending on the success of the offering, and hence higher underwriting commissions.

Level 3: subscribing for the entirety of the bond issuance with a view to selling the bonds later (at its own risk) to third party investors, which entails the highest degree of risk and highest level of underwriting commissions for the underwriter.

These three levels are illustrated in the diagram below:

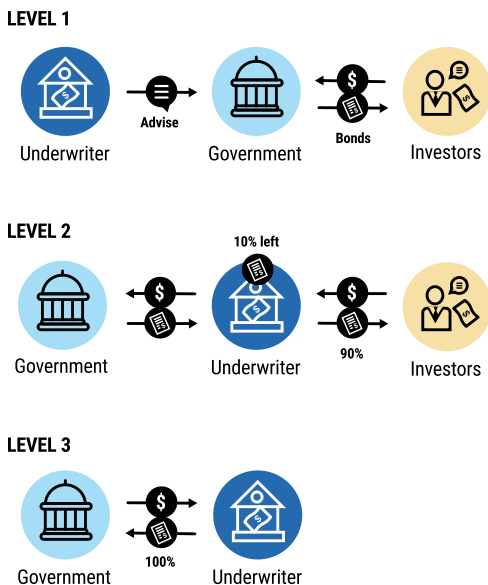


FIG.8. The three levels of underwriting



# 10 Secured Lending

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Secured lending is increasingly prominent as a form of financing on the continent, particularly with emerging, non-traditional creditors. This form of lending tends to be very complex and, although can be helpful in gaining access to new creditors and sources of financing, it is also highly risky and can cause intractable problems during times of distress.

## The World Bank Negative Pledge

When the World Bank makes loans to or with the guarantee of a member country, the General Conditions for Financing (as published from time to time) will be applicable to such extension of credit. The World Bank does not generally require security from the member country concerned in connection with such financing transactions. However, to protect the interests of the World Bank, the General Conditions include a negative pledge clause that strictly limits the ability of the member country to grant security in respect of foreign currency denominated obligations in favour of other lenders without also securing the World Bank.

The scope of the World Bank's negative pledge is broad, and covers not only “true” security interests such as pledges and mortgages, but also “privileges and priorities of any kind”. Importantly, it also restricts the granting of security by state-owned enterprises of the member country concerned, which often creates issues for national

oil companies and other large state enterprises who seek to borrow in the international markets. State-sponsored infrastructure and other projects financed in whole or in part from commercial sources need to be carefully structured to minimise the risk of breach. Historically, and as a matter of policy, the World Bank rarely grants formal waivers of the clause.

Most borrowings (e.g. through loans or bonds) or other financial exposures (e.g. through guarantees, counter-guarantees or indemnities) are unsecured, meaning payment of the financial obligations relies on the overall faith and credit of the sovereign obligor who will, in turn, rely on its resources and assets to pay the obligations. Occasionally, creditors will ask that their financial exposure rely on a particular asset of the obligor which should be set aside for them, exclusive of any other creditors or the debtor itself. This asset, the security for the obligation, set aside exclusively for the specified creditor(s), can be anything from real estate and bank accounts to gold reserves and future tax revenues, tolls collected for the use of an infrastructure project, future outputs of commodities (such as oil or gas) and receivables from the sale of such commodities.

Secured debt financing can take many forms and will depend either on the type of security asset or the form of financial instrument used. For example, real estate can be provided as security, either by way of **mortgage** over it to secure a financial obligation (such as a loan, bond or guarantee), or by a sale to the financial creditor who will then lease it back and grant a re-payment option to the sovereign debtor (a sale and lease-back transaction). The mortgage creates what is sometimes called a “classic security interest”, one which can be enforced (where the title to the real estate can be sold or appropriated) if there is a default by the debtor. Other classic security instruments are usually very explicit in their goal and functions and include various instruments such as pledges (typically for bank accounts, bonds, etc.) or security assignments (typically for receivables).

A **sale and lease-back agreement** is an example of an “effective security” instrument as it secures a payment through the immediate transfer of title to the real estate at the outset of the transaction and will require the lender immediately to lease it back to the borrower for a certain period of time. At expiration of the lease, the title of the asset is transferred back to the borrower. A **repurchase agreement** (also called “**repo**”) is another example of effective security as it will require the borrower to sell the asset to the lender and leave it in the custody of either the lender or a

third-party custodian. At expiration of the agreement, the lender will have the obligation to sell the asset back to the borrower for a pre-determined price which will include an amount equivalent to the interest that would have been applied on a equivalent loan. This type of structure is often used for gold reserves, oil receipts or entitlements to future output.

Other types of “effective” security include, for example, the advance purchase through **pre-payment** of a commodity output. An ordinary sale agreement, with the sale of goods in exchange for payment, is transformed into effective secured financing by a massive pre-payment in return for delivery of the goods over a very long period. Such long-term pre-payment contracts differ from repos as the commodity sold is ultimately taken by the lender, i.e. the person who pre-paid for it. Because of the transfer of title, effective security usually affords much greater certainty to the lender/purchaser. These structures are highly complex and can be costly in times of distress. Please see below for a more in-depth discussion.

Security can be granted either in addition to the sovereign’s overall faith and credit, or in the context of what is called **limited recourse financing**, usually relating to projects for infrastructure development or the development of energy assets. Limited recourse financing is focused on the asset or project being developed and limits the risks of the sovereign to that asset or project. In other words, even if the sale of the asset used to secure a borrowing does not cover the outstanding balance of such borrowing, the sovereign debtor will not have to cover the difference. There is, nonetheless, a residual risk for the sovereign. If the project has not been appropriately designed, if the private sector project sponsors are unable to complete the project or effectively exploit and maintain it, the sovereign may have to step in to cover these deficiencies. The sovereign can take steps to mitigate this risk, not only with proper upfront contractual design, appropriate procurement process to select the most suitable sponsors, but also by requiring appropriate financial backing from the sponsors in the event that they fail to perform to the level set contractually.

Other types of secured financing can emerge, depending on the circumstance and the inventiveness of the participants. For example, subnationals entitled to a share of revenues from the sale of the country’s commodities raise financing by discounting the future flow of receipts from their federal ministry by issuing, in favour of their financiers, irrevocable standing payment orders to the federal finance ministry. These forms of financing are often unreported and hide the true state of the

sovereign's overall indebtedness, and can, in times of stress, reveal considerable unexpected deficits. Debt managers should take care to follow such financings, record them, and where possible, bring them within their overall debt management.

### A CAUTIONARY TALE

Security granted by a sovereign, in addition to its overall faith and credit (i.e. not limited to the asset pledged), should be considered carefully. In case of non-satisfaction of their claims, these secured creditors can (and usually do) liquidate or take over the security granted to them and, in addition, can ask the sovereign to satisfy any shortfall from the liquidation of their security. This tends to create an uneven playing field among the sovereign's creditors and may push it to a very weak position as it offers to its creditors an immediate, and usually easy-to-achieve satisfaction of its financial claim. Where the security is over key assets of the sovereign (such as a part of its future oil or gas production), this is likely to adversely affect the ability of the sovereign to recover economically for considerable periods. Great care should therefore be taken before agreeing to financing arrangements that include non-limited recourse security.

Once a debtor, especially a sovereign debtor against whose assets enforcement is so difficult, starts granting (non-limited recourse) security to some of its creditors, the pressure from the other creditors to obtain security as well will be great as the comparative credit advantage of the secured over the unsecured creditors is immense. Unsecured creditors usually seek to protect themselves with negative pledge clauses which either seek to prevent the granting of (non-limited recourse) security altogether (typically in loans) or, as an alternative to the prohibition, require that the security be extended to them as well (typically in bonds).

## Pre-export Financing Agreements

Commodity-exporting countries, especially oil-exporting African countries, have increasingly resorted to pre-export financing agreements in recent years. The basic features of commodity pre-financing or pre-payment agreement can be summarised as follows. A trading company enters into a commercial contract with a commodity exporter (in most cases, the national oil company); the exporter commits to sell a predefined number of cargoes over a given period of time, and the trading company

commits to buy them at a price usually based on prevailing market conditions at the time of the sale following a pre-defined formula. The trading company is asked to pre-pay (i.e. finance) a fraction of the future cargo sale proceeds, based on an agreed interest rate, payment frequency, and maturity (usually in the form of a maximum authorised outstanding debt amount at each anniversary date.) The resulting debt is then redeemed automatically every year by the allocation of a given percentage of each cargo delivery sale. This continues until the maximum authorised outstanding debt amount is reached.

In some respects, such arrangements have attractive features, in that they are easy and rapid to conclude, do not require heavy due diligence, and usually include reasonable interest rates. However, the all-in cost to the sovereign often substantially exceeds the externalised interest rate, given the fees payable (arrangement fees, agency fees, etc.) as well as various clauses providing for step-up interest payments under various circumstances (late payments, default, etc.). Moreover, the trading companies may derive additional “hidden” remuneration in the way the sale price formula is negotiated, including, for example, discounts to market price and or other features which effectively make the traders “price makers” in the transaction.

From a public finance perspective, these contracts are difficult to manage because they may prevent the sovereign from accessing significant revenues when most needed as it entails pro-cyclical features likely to accelerate a debt crisis in difficult times.

For example, in case of a drop in international oil prices or a downturn in oil production, there is a high risk that cargoes available to the trader will not generate enough proceeds to repay the pre-financing. When this happens, mechanisms of interest rate hikes are triggered. This forces the renegotiation of the repayment amortisation schedule, with additional fees to be paid to the traders. All of this happens in a context where the country is at the same time severely hit by the decrease in available oil revenues. For this reason, the sovereign should always consider these agreements with care and ensure transparency from the national oil company when it enters into this type of agreement.

# 11 Swaps

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Interest rate swaps and cross-currency swaps are often used by sovereigns to hedge interest rate and foreign exchange risk. They are examples of over-the-counter (OTC) derivatives transactions.

## Interest Rate Swaps

A typical interest rate swap involves one party agreeing to pay a floating rate of interest on a notional principal amount, in exchange for a fixed rate of interest on the same notional principal amount. Principal amounts are not exchanged. The interest rate payments will be made on scheduled payment dates during the term of the interest rate swap transaction.

A sovereign which has borrowed money (for example, USD 100 million) at a floating rate of interest (for example, on a LIBOR basis) payable semi-annually might wish to hedge the risk of LIBOR increasing. It could hedge that risk by entering into an interest rate swap with a bank. The bank would agree to pay to the sovereign LIBOR on a notional principal amount of USD 100 million on the same interest payment dates as the loan, and the sovereign would agree to pay to the bank a fixed rate on the same notional principal amount and on the same payment dates.

The effect for the sovereign is that it pays a fixed rate under the swap and receives the floating rate that it needs to pay to its lender.

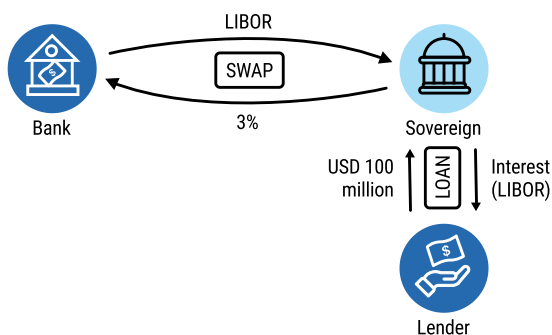


FIG.9. Interest rate swap

## Cross-Currency Swaps

A cross-currency swap involves one party agreeing to pay a rate of interest (which could be fixed or floating) on a notional principal amount denominated in one currency, in exchange for a different rate of interest (which could be fixed or floating) on a notional principal amount denominated in another currency. Unlike interest rate swaps, principal amounts are exchanged at the beginning and at the end of a cross-currency swap transaction. The interest rate payments will be made on scheduled payment dates during the term of the transaction.

A sovereign which has borrowed money (for example, USD 100 million) at a floating rate of interest (for example, on a LIBOR basis) payable semi-annually, might wish to hedge both the risk of LIBOR increasing and the risk that its own currency depreciates against the US dollar (USD). It could do so by entering into cross-currency swap with a bank. At the start of the transaction, the bank would agree to pay to the sovereign the local currency equivalent of US\$ 100 million and the sovereign would pay USD 100 million (the amount that it borrowed) to the bank. During the term of the transaction, the bank will pay to the sovereign LIBOR on a notional principal amount of USD 100m on the same interest payment dates as the loan, and the sovereign will pay to the bank a fixed rate on a notional principal

amount equal to the local currency equivalent of USD 100 million on the same payment dates. At maturity of the transaction, bank will pay to the sovereign USD 100 million (allowing bank to repay its USD debt) and sovereign will pay to the bank the same amount in local currency that it received at the start of the transaction.

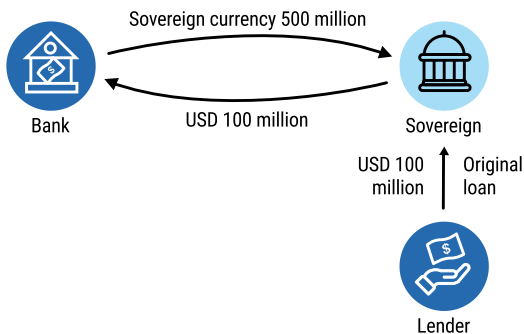


FIG.10. Cross-currency swap (initial exchange)

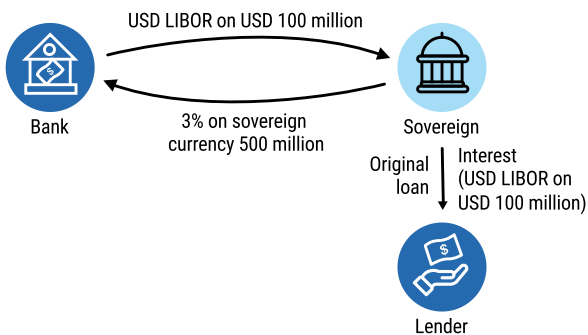


FIG.11. Cross-currency swap (ongoing payments)





FIG.12. Cross-currency swap (final exchange)

The effect for the sovereign is that it has hedged both interest rate and foreign exchange risk associated with the USD loan.

## Commodity Price Swap

In addition to hedging interest rate and currency risk through a swap, a sovereign might also wish to hedge commodity price risk (the risk that prices for commodities that it exports will drop). It could do so by entering into a commodity price swap under which it agrees to pay an amount to its swap counterparty if the commodity price exceeds an agreed-upon level and to receive payments if the commodity price is below that level.

## Swap Agreements

Interest rate swaps and cross-currency swaps are usually entered into OTC: they are privately negotiated and not subject to the standardisation that would be required for contracts listed on an exchange, although swaps are sometimes available on trading platforms.

Although executed bilaterally between two contracting parties, certain types of OTC derivatives – those that are relatively standard and which have not been customised – may be cleared through clearing houses. Non-standard and customised OTC derivatives remain bilateral transactions throughout their term.

The contracts required to support OTC derivatives are complex. They are often based on standard forms, including a master agreement, published by the International Swaps and Derivatives Association, Inc. (ISDA) but they can be heavily negotiated.

Although derivatives are designed to reduce risk for one party (for example, interest rate risk for the sovereign) by shifting that risk to another party, one of the consequences for a party entering into a derivative is that it takes on credit risk; the risk that its counterparty fails to perform on what would otherwise be a valuable transaction for that party. There are several techniques for mitigating and reducing this risk.

One of the most important techniques is “netting”. ISDA’s master agreement contains close-out netting provisions – provisions in the agreement that allow one party to terminate outstanding transactions if the other party defaults and, having terminated, to calculate a single net amount payable between the parties reflecting the costs (or gains) of the non-defaulting party in replacing the terminated transactions.

Another common technique for reducing credit risk is collateralisation. It is common for parties to OTC derivatives to exchange margins in the form of cash and/or securities.

## Repos

Sovereigns also use “repo” transactions, as described in the Chapter “Secured Lending”, as a means of raising finance. As with swaps, the seller exchanges assets with the buyer for cash with a fixed retransfer date. Repo transactions are documented in a similar manner as swaps and may also rely upon market-standardised documentation.

# 12 Shari'ah Compliant Sovereign Debt

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The sovereign bond market has seen a significant increase over the past decade in the issuance of a form of borrowing that is structured to be compliant with Islamic Law, also known as Shari'ah (the arabic term for law). Shari'ah-compliant bonds may be an attractive option for sovereign borrowers who are seeking to market to investors in markets where Shari'ah compliance may be mandated for or preferred by institutional investors, sovereign wealth funds and private investors.

In general, Shari'ah compliance stems from prohibitions under Islamic financial law against the resale of debt contracts, the generation of profits without an associated economic activity, and the use of financing to support prohibited goods/activities (i.e. alcohol, pork products, weapons, adult entertainment, and gambling). From an economic perspective, Shari'ah compliance differs from traditional lending in that the lender may only earn profits through participation in the activity that is being financed, and even then, only if the investment produces a profit.

The most common Shari'ah-compliant bonds at the moment are the "Sukuk" (the Arabic term for certificates), which are most similar to asset-backed bonds. The general structure of a Sukuk requires that the funds generated by the sale of the instrument be placed in a special-purpose vehicle (SPV), after which the SPV will invest in Shari'ah-compliant activities. The investors in the Sukuk will then share in

any profits generated by the portfolio of investments held by the SPV, such as through profit-sharing from a corporate investment or lease proceeds from investment in real property. These bonds will be issued under similar diligence standards as sovereign bonds, including rating by CRAs.

There are various other structures replicating in a Shari'ah-compliant manner the economic equivalent of loans, known as Murabaha, and leasing, known as Ijara.

Murabaha structures vary but in essence replicate the following pattern: at the same time, the effective borrower sells goods to the effective lender for 100, with immediate settlement, and sells the same goods for more than 100 (say 120) back to the effective borrower on deferred payment terms.

Ijaras are structured very much like leases, with the rental payments calculated in advance as fixed payments.

For sovereign borrowers, it is important to recognise that issuing Sukuks or other Shari'ah-compliant forms of borrowing will require both additional structuring at the outset (i.e. legal fees) and monitoring over the life of the security (to maintain Shari'ah compliance). The limited nature of activities that may be funded through Shari'ah-compliant instruments may also provide a challenge for debt managers.

# 13 Contingent Liabilities

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Contingent liabilities are discussed in detail in this chapter. These are potential liabilities which become actual liabilities upon the occurrence of a future event. Just because they do not make an immediate demand on the sovereign's cash flow, they should not be overlooked by the government and the public debt managers. In fact, their potential size in extraordinary times could dwarf the size of the sovereign's actual liabilities in ordinary times.

Debt managers should ensure that the impact of risks associated with contingent liabilities on the government's financial position is taken into consideration when designing debt management strategies. Contingent liabilities represent potential financial claims against the government that have not yet materialised, but that could trigger a financial obligation or liability under certain circumstances. Contingent liabilities produce an "iceberg" illusion, in that one can see certain liabilities but not all of them, due to their contingent nature. This type of liability has grown dramatically in importance in the last three years, and in some cases has resulted in very costly fiscal surprises.

Recent history on the continent shows that contingent liabilities are a significant source of fiscal risk. In several cases, failure to disclose and prepare for such risks has led to large increases in public debt and triggered fiscal crises.

The following diagram illustrates the potential magnitude of the liabilities in the “iceberg” illusion:

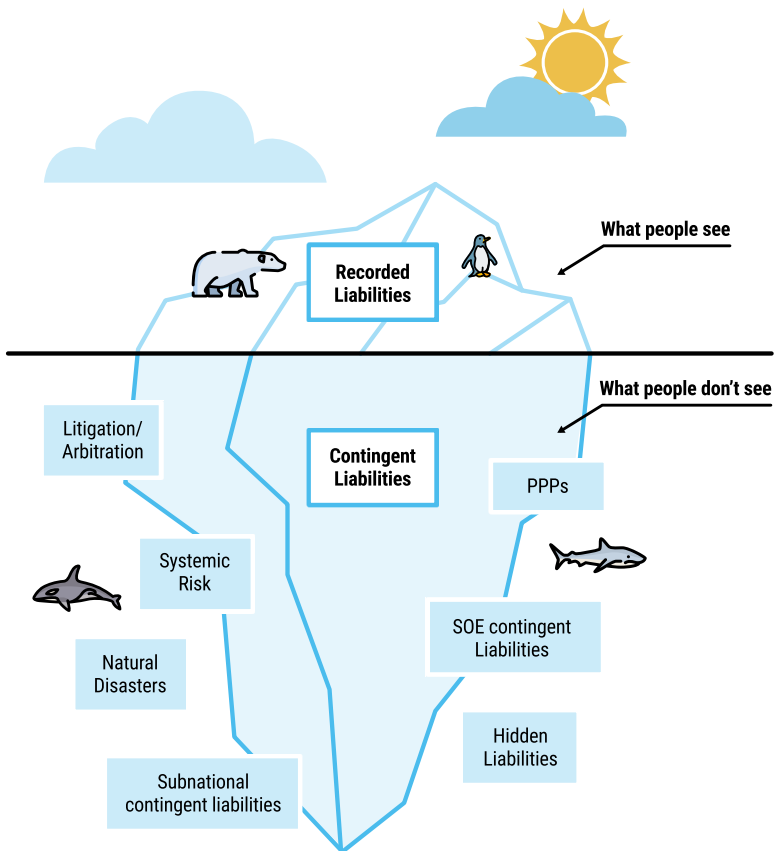


FIG.13. The contingent liabilities "iceberg"

The following types of contingent liabilities and their consequences are considered in this chapter:

1. Explicit contingent liabilities arising out of express contractual obligations such as credit enhancements and other credit support instruments. These include guarantees, counter-guarantees, indemnities and price-support mechanisms.
2. Implicit contingent liabilities arising out of the sovereign's public service and general political economy obligations, such as support for the pension system and the health and education services.
3. Systemic contingent liabilities arising out of “too-important-to-allow-to-fail” obligations of the sovereign, such as the obligation to maintain a banking system and an energy sector. (This is where the term, as used here, differs from that standard accounting/debt statistical definition)
4. Subnational contingent liabilities.
5. Arbitration claims arising in ordinary times which may create a financial obligation of the sovereign.

Policymakers recognise that contingent liabilities are a potential risk to sovereign debt sustainability. This will be explained in more detail under “A special note on contingent liabilities” in the Chapter “Recording, Reporting and Maintaining Good Debt Data”.

## Explicit (or Legal/Contractual) Contingent Liabilities

Explicit contingent liabilities are expressly set out in a lending (or other) document. They take the form of government guarantees, counter-guarantees, indemnities and other price support mechanisms. These are generically referred to as “credit enhancement” or “credit support”.

## Guarantees

A guarantee is an undertaking by a person (the “guarantor”) to answer for the payment or performance of another person's debt or obligation (the “primary obligor” - which can be an SOE or another entity supported by the government) to a third-party creditor (the “creditor” - which can be a lender or another type of counterparty to a contract) in the event of non-payment or non-performance of the obligation by the primary obligor. A guarantee is an extremely common and recognised form of credit support. As with all credit enhancement instruments, great care should be taken when in drafting and understanding them. In particular, sovereign debt managers should be clear on (a) the extent of the guaranteed obligations and (b) the trigger which entitles the creditor to demand payment or other performance under the guarantee.

When providing guarantees, the government will only assume the obligations of the primary obligor if the primary obligor fails to pay or otherwise perform its obligations under its contract with the creditor. So, from the perspective of the debt manager and the sovereign manager, guarantees have the advantage of being an effective credit enhancement instrument without direct impact on the government's liquidity.

Guarantees can be issued directly to the creditor, or indirectly through another state entity or agency.

### **DIRECT SOVEREIGN GUARANTEES**

African sovereigns often issue direct **sovereign guarantees**, in the context of infrastructure projects.

Guarantees may be documented as “stand-alone” separate documents, or they may be included in other documents (e.g. the debt contract between the creditor and the primary obligor) which will cover many other matters in addition to the guarantee.

Direct sovereign guarantees can take various forms and may sometimes appear under different names. This will be due to the nature of the overall arrangements between the creditor and the primary obligor or the conventions of the market within which they operate.



For example, in the case of large infrastructure projects, guarantee provisions may be included either in stand-alone documents or be embedded in one of the many documents of such a project, such as implementation agreements, concession agreements and government support agreements/letters of comfort. They may also take the form of put-and-call option agreements, also in the context of large projects or direct investments (with the put-and-call being for either the shares in an enterprise or its assets).

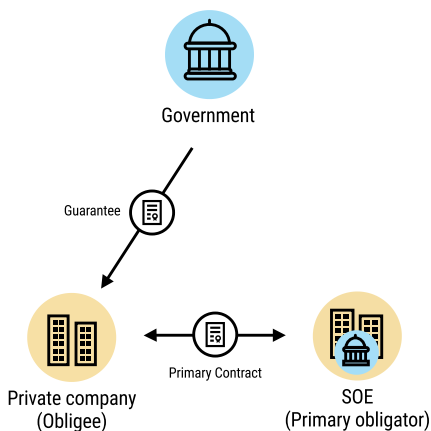


FIG.14. Direct sovereign guarantees

It is therefore important for governments and debt managers to focus on the function of the effective guarantee instrument, analyse the arrangements with great care and not necessarily focus on the name or exact form in which the effective guarantee is presented.

The scope of guarantees varies enormously. They can range from a simple guarantee limited to covering a termination payment to the creditor, to a guarantee of every single financial payment, or other loss, cost, or expense of the creditor. Nevertheless, the main purpose of a sovereign guarantee is always the same: to enhance or support the creditworthiness of the primary obligor. Although the government's liquidity is not immediately affected, its assets and revenues are at risk.

## INDIRECT OR COUNTER-GUARANTEES

An indirect or counter-guarantee arises when the government agrees to guarantee the obligations of another guarantor as opposed to the obligations of the primary obligor.

There are at least four parties involved when a counter-guarantee is issued by a government: the government itself as counter-guarantor, the primary guarantor, the primary obligor and the creditor. The primary guarantor is typically a financial institution with a high credit rating. The counter-guarantee adds another level of credit enhancement for the underlying transaction, as the creditworthiness of the counter-guarantor will also be considered by the creditor (and any other interested parties such as rating agencies etc.) in their credit analysis of the transaction.

A financial institution (the primary guarantor), for example, might require a counter-guarantee from the government to agree to issue a letter of credit in favour of a private company (the creditor). For the government, the granting of a counter-guarantee to the primary guarantor has an equivalent credit risk to the granting of a guarantee directly in favour of the creditor. The creditor may however only be able or prepared to enter into the primary contract if the credit support comes to it from the financial institution/primary guarantor.

Another example of the use of a counter-guarantee is in the context of a **partial risk guarantee** (PRG). The PRG is an instrument issued by a multilateral bank (the primary guarantor) to a private entity (the creditor) to guarantee a specific number of payments under an infrastructure or other large-scale project. In turn, the multilateral bank (the primary guarantor) will require the government (as counter-guarantor) to counter-guarantee the obligations of the multilateral bank under the PRG. If the multilateral bank is required to make a payment under the PRG, it will request reimbursement from the government under the counter-guarantee. As a result, the government will have a liability which is contingent on the risk that the multilateral bank makes a payment under the PRG.

It is important to note that because of the counter-guarantee, the PRG structure will create a contingent liability similar to the one created under a direct guarantee by the government in favour of the creditor. This is because the risk is ultimately the same, i.e. the default of the primary obligor (typically an SOE) to the creditor under the contract guaranteed by the PRG. For the government the advantage of the PRG lies in the government's ability to obtain better financing terms for the primary obligor

(its own SOE) as the risk for the creditor is reduced through the mediation of the multilateral bank as primary guarantor.

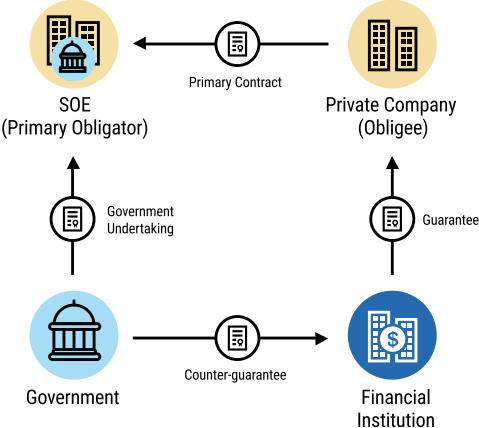


FIG.15. Counter-guarantee structure

**EXPORT CREDIT COUNTER-GUARANTEED BY THE SOVEREIGN**

Most developed countries have specialised export credit agencies (ECAs). Some prominent examples of ECAs are the US Export-Import Bank (US EXIM), Coface (France), SACE (Italy), Hermes (Germany), and ECGD (United Kingdom). Foreign enterprises wishing to do business in the territory of the sovereign or with nationals of the sovereign may get support from one or more of the ECAs (or other export risk insurance) agencies of their own country. Loans that are made with the ECA cover generally have market interest rates, and longer maturities than can be generally provided by private lenders.

While finance through official ECAs is crucial for some products (such as aircraft), government intervention in the export credit business is mainly to insure, or guarantee, private export credit. In all of these cases, the guarantee (or other support) given by the ECAs will be counter-guaranteed by the sovereign, and, to the extent that the ECA guarantee is called, the underlying debt will become a government-to-government debt. Debt managers should therefore monitor the

sovereign's exposure through such ECA counter-guarantees, taking note whether the ECA cover is provided by members of the Paris Club or not.

## Indemnities

Government support can also take the form of an agreement to indemnify a party in the event of a loss. Such indemnities are broader in their scope as compensation mechanisms, but have ultimately similar effects to those of comprehensive guarantee or counter-guarantee.

For example, an insurance for political risk issued by a multilateral bank to ease the fundraising efforts for a specific infrastructure project will typically require the government to agree to indemnify that multilateral bank if a claim is made under the insurance policy. For this purpose, a liability contingent on the risk of a claim under the political risk insurance will be created by the indemnity, and should be recorded as a contingent liability.

The key difference between indemnities and guarantees is that under a guarantee claim, the guarantor will be liable only for a well-founded claim. An indemnity claim will not consider whether or not the indemnified party *should have* suffered a loss, but only if it *has in fact* suffered a loss. It is technically easier to get compensated under an indemnity than under a guarantee.

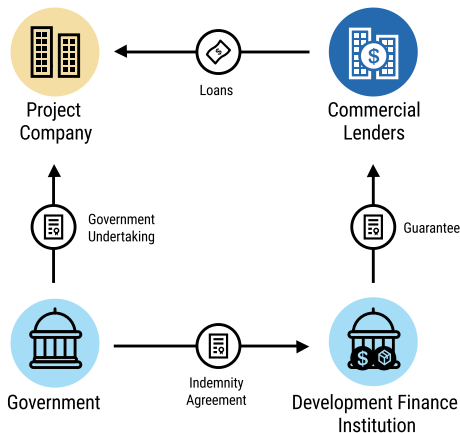


FIG.16. Indemnification structure

## Price Support Undertakings

Price support undertakings are agreements to intervene if the revenue anticipated by the creditor proves to be less than a pre-agreed minimum “floor” amount (the “minimum expected revenue”). The revenue fluctuation may be linked to commodity prices, currency exchange rate or other relevant factors, and thus the compensation mechanism may vary significantly from one agreement to another, depending on the nature of the risk guaranteed by the government. Ultimately, however, once the creditor claims a shortfall, the government will pay the difference between the minimum expected revenue and the actual revenue.

Price support undertakings therefore serve a function similar to a guarantee. The contingent liabilities they create should be analysed and assessed with the same care and rigour.

## Key Considerations for Explicit Contingent Liabilities

Credit enhancement instruments giving rise to explicit contingent liabilities may vary greatly in their scope. They can range from a full guarantee of all of the primary obligor's obligations under the primary contract, or they may be limited to specific types of losses, size of amounts, or circumstances in which they can be called.

Credit enhancement instruments may also cover risks that are not included in the primary contract, but which by nature are considered to be under the control of the government (e.g. political risk). The terms of credit enhancement instrument will therefore depend on several factors, including the creditworthiness of the primary obligor, the nature of the risks covered, and whether other credit enhancement instruments are in place.

The government must have a clear understanding of the nature of the primary obligor's obligation to the creditor. The government should always analyse both the terms of the credit enhancement instrument it is being asked to provide and the primary contract. Failure to do both may result in a serious miscalculation of the nature and scope of the contingent liability assumed.

The government should retain the right to be formally informed of any notice of breach/default (however minor) delivered to the primary obligor in respect of the supported obligations or in respect of the primary contract. The government's credit enhancement instruments should not be capable of being extended to cover liabilities arising under the primary contract if this primary contract is amended or its terms waived without the government's prior consent. The government should retain the right to cure any breach/default before such breach/default leads to the termination of the primary contract (resulting in the calling of the relevant instrument) as the cost of the cure may be substantially less than any payment due under the credit enhancement instrument.

# Implicit Contingent Liabilities

Implicit liabilities do not have express legal documentation (or any other type of express recognition), but the sovereign can exercise its sovereign discretion and recognise a liability once they materialise. These are mostly triggered by social pressures (such as the failure of a pension fund scheme).

## “Systemic” Contingent Liabilities

However sound the overall management of an economy is at the sovereign level, the sovereign may still find itself challenged in extraordinary times by systemic risks beyond the control of the sovereign. These systemic economic risks raise a number of challenges not present in ordinary times. Mitigating these risks may require the sovereign to provide support to sectors of its economy even though it has no contractual obligation to do so (unlike in the case of its debt securities, loan agreements, credit enhancement instruments it has signed etc.).

Since the economic strength of a sovereign derives from the economic activity within its market, the sovereign is effectively dependent upon key market sectors to implement its economic policy and debt management strategy. For example, the financial collapse of the domestic banking sector, over-indebtedness of the corporate sector, or technical disruption of the power sector, would cause a drop in economic activity and, by extension, a weakening of sovereign wealth and growth. Each sovereign's banking, corporate, and energy systems may differ, but, if any of them faces insolvency, the sovereign needs to be prepared to step in and take action, including bailouts in extreme circumstances. If action is not taken, the entire system, or at the very least, those parts without which the system cannot survive, risks collapsing.

Prudent debt management therefore dictates that the financial health of critical sectors such as banking, corporate, and energy should be monitored in an appropriate way that respects the institutional independence of the actors in the

banking and energy sectors whilst ensuring that the risks to these sectors are adequately managed and, if required, appropriately supported.

## Liabilities of Subnationals

### **FEDERAL STATES, REGIONAL GOVERNMENTS, MUNICIPALITIES**

Certain sovereigns, especially geographically larger ones, may have a devolved administration system. This system may include anything from states associated in a federation, to regional governments, each one of which has its own governance system. In addition, large urban or systemic trade areas may enjoy the benefits of municipal or other forms of local government.

In each case, these subnational entities will have their own budgets and will manage them in an independent manner. Once again, prudent debt management requires that their liabilities as well as their revenues and other assets be monitored, as, in extraordinary times, any one of these subnationals may find itself in financial difficulties. In such cases, the sovereign may need to extend assistance to one or more of these subnationals, possibly even requiring the sovereign to assume their outstanding debt liabilities, which in turn means a further liability that must be accounted for in the sovereign's overall debt management strategy.

## Arbitration Claims

A sovereign is likely to have entered into bilateral investment treaties (BITs) with other sovereign countries. Such treaties afford a host of protections to private investors resident in these countries and investing in the host sovereign country. These protections cover most types of foreign direct investment and even extend, in many cases, to investments in sovereign debt securities. BITs usually allow such investors to take to arbitration any claims they may have against the sovereign for not affording them the proper level of protection provided under the treaty.

In the event that the arbitration results in an award for a compensation payment against the sovereign, it will be important for debt managers to take into account the need to satisfy that award. Debt managers will have to consider whether non-



payment of the award, or even a simple delay in payment, will have an impact on the obligations of the sovereign under any of the sovereign's debt instruments (such as triggering cross-default provisions), or may result in attachment orders against assets of the sovereign.

Potential investors in debt securities offered by the sovereign will factor in outstanding arbitration awards in their internal risk assessment, and over time the sovereign may pay a significant risk premium for non-payment of awards. More generally, non-payment of awards is likely to adversely affect all foreign direct investment.

In certain circumstances, arbitration awards can be transferred or traded on the secondary market. Governments and debt managers should follow these developments as they are likely to signal a more concentrated effort by specialised funds to pursue these claims with increased vigour.

Arbitration awards obtained in the context of disputes concerning foreign direct investment should be distinguished from arbitration awards or court judgements which may be issued against the sovereign in the context of a distressed debt situation or a debt restructuring. The former arise even in ordinary times whereas the latter only in extraordinary ones.

## Magnitude of Potential Impact of Contingent Liabilities

By their nature, the crystallisation of contingent liabilities is hard to predict. Moreover, once contingent liabilities start to become actual, they tend to accumulate fast, often into a snowball effect. One failure leads to another, and another, and so on.

The challenge for the debt manager is to devise a system of monitoring and analysing contingent liabilities, and deciding how to budget for their potential budget impact.

Recording, accounting, reporting and monitoring of contingent liabilities is discussed in detail in the Chapter Recording, Reporting and Maintaining Good Debt Data.

# Public Debt Management



## *Key Points*

*Managing the profile and portfolio of public debt responsibly is essential given the severe macroeconomic consequences of public debt defaults.*



*Effective public debt management will ensure that the government's financing needs and its payment obligations are met at the lowest possible cost over the medium-to-long term, consistent with a prudent degree of risk.*



*A coherent debt strategy that assesses related costs and risks of financing options will be critical for making responsible borrowing decisions and can contribute to the development of a functioning domestic capital market.*



*Good debt data is critical for the performance of the various debt management functions, particularly for contingent liabilities as they can lead to “unexpected” consequences.*



*Debt managers have access to various tools and resources produced by the IMF and The World Bank to assist developing countries in improving debt management.*



# 14 Functions, Frameworks and Tools

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## Importance of Public Debt Management

Public debt management is the process of establishing and executing a strategy for managing a government's debt. This is done in order to raise the required amount of funding at the lowest possible cost over the medium-to-long term, consistent with a prudent degree of risk, and to meet any other public debt management goals, such as developing and maintaining an efficient market for government securities.

The scope of public debt management should encompass the main financial obligations over which the public sector exercises control.

Poor debt management can often adversely affect a sovereign's fiscal sustainability, with implication for its credit rating and financial flows.

Public debt management is important for several reasons, namely:

## LOWERING GOVERNMENT'S COST OF BORROWING

A critical element of debt management is to assess and monitor the cost of debt servicing and accumulation of arrears, which often reduce the volume of resources available for other uses. A reduction in financial resources, for example, can impact a government's ability to spend on essential social sectors such as health and education. Sound public debt management can help lower a government's debt servicing costs by giving confidence to creditors.

## RISK MANAGEMENT IN THE DEBT PORTFOLIO

Embedded in the public debt portfolio are complex and risky financial structures, generating substantial risk to the government's balance sheet and to the country's financial stability. Effective public debt management ensures that these risks are carefully managed and monitored so that they do not significantly expose the portfolio to an increase in expected costs and to risks associated with public debt and its management.

Examples of risks encountered in debt management are provided in the box below.

### Examples of risks to be managed

1. Market risk: adverse changes in market conditions (e.g. interest rates, foreign currency exchange rates or commodity prices) can result in the increase of debt servicing costs or missed opportunities to reduce such costs.
2. Refinancing risk: when refinancing existing or maturing obligations, there is a risk that market access could be limited or only available at higher rates.
3. Liquidity risk: it might not be possible to sell an obligation promptly or cost-effectively.
4. Credit risk: a counterparty might fail to make required payments on time or in full.
5. Operational risk: poor recording, unverified data, or other errors that could occur when transferring data from one system to another, could result in under- or overpayment of obligations.

## **CONTRIBUTION TO MACROECONOMIC STABILITY**

Poor and inadequate public debt management contribute to debt sustainability problems in many developing countries, fuelling monetary and economic instability. It also has implications for the effectiveness of formulated macroeconomic policies and for other elements of government financial management. To the extent possible, the day-to-day implementation of sound debt management policies should reinforce the objectives of macroeconomic policies and of policy reforms aimed at improving the efficiency of the domestic financial markets. Prudent debt management thereby helps countries achieve macroeconomic stability, a pre-requisite for sustainable growth and development.

## **DEVELOPMENT AND MAINTENANCE OF AN EFFICIENT MARKET FOR DOMESTIC GOVERNMENT SECURITIES**

In most countries, decisions by government debt managers have been important catalysts in developing the overall structure of the domestic securities market. These decisions include which types of instruments to issue, the most appropriate issuance strategy and market infrastructure for supporting these instruments - all of which are critically important to the development of domestic capital markets.

Decisions of the public debt manager can also have a positive impact on the country's private sector. Domestic financial institutions benefit from having available public debt instruments in which to invest and that can provide benchmarks for the pricing of other instruments, including corporates.

Moreover, a well-developed domestic financial market can facilitate economic development and make the economy more resilient to external shocks, such as capital outflows.

## **PROTECTION OF GOVERNMENT'S REPUTATION**

The quality of government debt management practice can have important effects on a government's reputation and affect the market's judgment of the government's financial management and competence, and ultimately its credit rating and risks. It is essential that the government's debt is managed according to the highest ethical and professional standards.

## Functions of Debt Management

Debt management has a number of different functions. These include:

### **POLICY FUNCTION**

This function involves defining the objectives of government debt management and developing the corresponding debt strategy. The objectives and the debt strategy are embodied in the overall macroeconomic strategy of a country (depending on the country's economic development strategy) and will provide elements for the decision on the desired cost and risk, maturity structure, currency composition, interest rate structure, etc.

### **REGULATORY FUNCTION**

This function involves the establishment of a well-defined legal and regulatory framework in order to facilitate the achievement of the debt management objectives. This should include a comprehensive legal framework with a consistent set of laws reflected in a public financial management act, or at a minimum, a public debt act, and fiscal responsibility laws. This regulation may also dictate the rules for public entities and subnationals to guide their issuance of securities and other forms of borrowing.

In addition, there should be an institutional framework with rules and regulations for each of the institutions involved in the public debt management operations.

Last but not least, an organisational framework with the functions manuals, procedures manuals and job descriptions for all the institutions and personnel involved, is required.

### **TRANSPARENCY AND ACCOUNTABILITY FUNCTION**

An important aspect of debt management is the public disclosure of materially important aspects of debt management operations, particularly the outstanding stock and composition of its debt liabilities and financial assets, and, where they exist, contingent liabilities.

The legislature and the public should also be informed, through an annual report, of the context in which debt management operates and the outcomes of the debt management strategy (DMS).



## Institutional Framework for Debt Management

Responsibilities and accountabilities of each party involved in debt management activities should be clearly structured (as shown in the diagram below). The governance arrangement generally starts from the parliament/congress/national assembly, based on the constitutional set-up of the country. Following that, the relevant powers for various debt management functions are conferred to the ministry of finance/council of ministers and/or central bank.

Operational responsibility for debt management activities is then generally separated into front, middle, and back offices with distinct functions and accountabilities, and separate reporting lines. In some African countries, these offices are consolidated in a single debt management office (DMO), while in others, these offices are fragmented across several departments within the ministry of finance, and some are located in the central bank.

Regardless of the institutional set-up, clarity of roles and responsibilities, policy coordination, information-sharing, transparency and accountability, are critical for effective debt management.

### **FRONT OFFICE**

The front office has the responsibility of mobilising resources from both domestic and external sources at minimum cost and on time. The front office typically implements the borrowing plan based on the DMS approved by the government; negotiates with creditors; liaises with market players; regularly reviews the market conditions, and provides information to donors/creditors, international financial institutions, commercial banks, etc.

### **MIDDLE OFFICE**

The middle office is responsible for providing advice and analysis that enable the government to meet its financing needs at the lowest possible cost within a prudent level of risk. The middle office monitors the front office's performance in terms of compliance with the chosen strategy, cost and risk limits, as well as assesses and coordinates all types of risks — market, refinancing, liquidity, credit, operational and contingent.

Some examples of middle office functions include determining borrowing ceilings for government consistent with fiscal and monetary policy requirements; formulating a debt strategy; providing reliable forecasts of debt servicing that inform fiscal forecasts; and performing debt sustainability analysis on a regular basis. Monitoring contingent liabilities may also be a middle office responsibility.

## **BACK OFFICE**

The back office is typically responsible for debt registration, for handling transactions confirmations, settlements and payments, as well as for maintaining records of all debt contracts, disbursements, payments, debt restructuring agreements, on-lending arrangements, issued guarantees, settlement of transactions, etc. The back office is also responsible for providing projections of debt servicing and disbursements to inform the budget planning process.

## **Public Debt Audit**

Public borrowing and debt entail significant risks if they are not managed properly. Supreme Audit Institutions (SAIs) can play a significant role in improving public debt management and prevent public debt from reaching unsustainable levels.

Regular financial and performance (value for money) audits of public debt are essential elements to guarantee public debt managers are held accountable for their public debt actions. Performance audits of public debt can contribute to enhancing the effectiveness, efficiency and economy of debt management, and provide greater transparency of the risks and benefits of public debt.

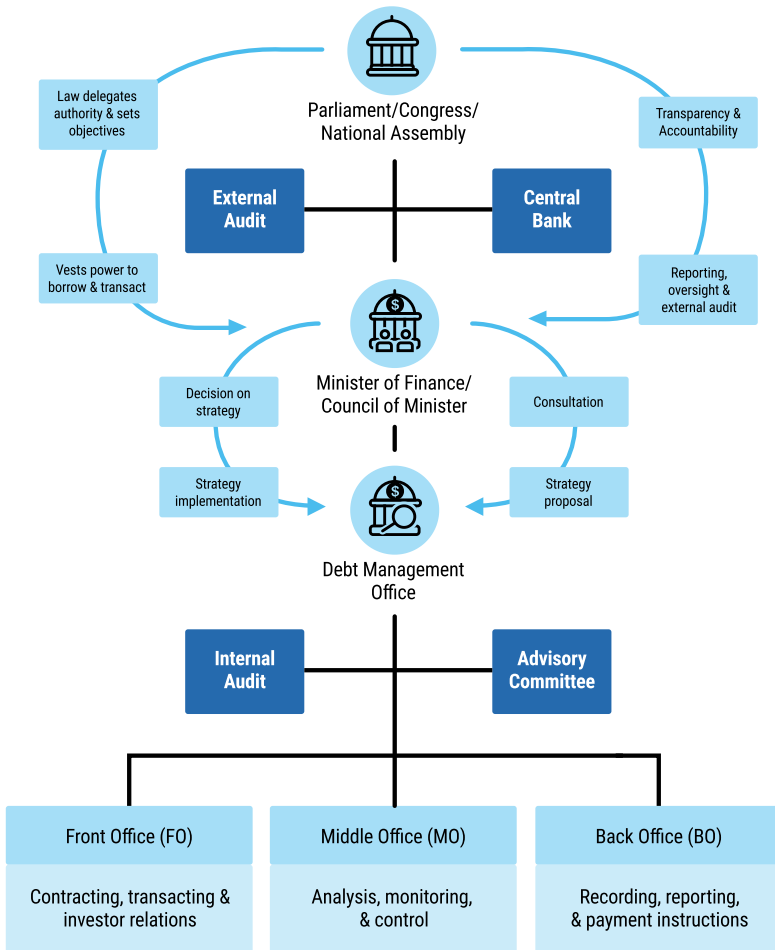


FIG.17. Debt management governance framework

SAI audit reports should have the potential to influence policymakers and, therefore, result in a significant contribution to improving public debt management. For example, SAIs could (1) enhance public debt transparency and accountability by examining current reporting practices; (2) strengthen internal control in public debt programs to reduce risks of fraud and corruption; and (3) modernise public debt's legal framework by examining best practices identified in the International Standards of Supreme Audit Institutions (ISSAIs) public debt audit guidelines.

SAI audit reports are presented on an annual basis to the legislature and are consequently in the public domain and so available for public inspection.

## Resources and Tools for Effective Debt Management

This section provides a brief overview of resources and tools currently available to government officials responsible for performing some of the above-mentioned functions, including recording and analysing debt data and strengthening debt management.

1. Debt Management Information Systems (recording and maintaining debt data)
2. Debt Sustainability Framework for low-income countries (LICs) (analytical functions)
3. Debt sustainability analysis for market access countries (analytical functions)
4. Medium-Term Debt Management Strategy (MTDS) toolkit (analytical functions)
5. Sovereign Asset and Liability Management (SALM) framework (analytical functions)
6. Debt Management Performance Assessment (DeMPA) (strengthening debt management)

### **DEBT MANAGEMENT INFORMATION SYSTEMS**

UNCTAD's Debt Management and Financial Analysis System (DMFAS) are the two main debt management information systems that assist countries to record and manage debt by providing a comprehensive repository for external and domestic debt data, both public and private, on an instrument-by-instrument basis, as well as tools

to analyse and manage the loan portfolios. Both systems are regularly enhanced to reflect changes in instruments, creditor practices, debt reporting standards, and technology in order to represent best practice in debt management.\*

## **DEBT SUSTAINABILITY FRAMEWORK FOR LOW INCOME COUNTRIES (LIC-DSF)**

The IMF and the World Bank have developed a framework to help guide countries and donors in mobilising the financing of LICs' development needs while reducing the chances of an excessive build-up of debt in the future. Since its inception in 2005, the Debt Sustainability Framework (DSF) has become the most popular tool for analysing debt sustainability in LICs, however other econometric tools exist. Under the DSF, debt sustainability analyses (DSAs) must be conducted regularly.

A DSA consists of: (a) an analysis of a country's projected debt burden over the next 10 years and its vulnerability to economic and policy shocks—which is calculated using baseline assumptions and stress tests; (b) an assessment of the risk of external and overall debt distress, based on indicative debt burden thresholds and benchmarks, respectively, that depend on the country's macroeconomic framework and other country-specific information.

The assessments are performed through standardised templates, and are conducted in the context of both the IMF financing and Article IV surveillance. Furthermore, DSAs are used to determine a country's access to IMF financing, as well as for the design of debt limits in IMF-supported programs, while the World Bank uses it to determine the share of grants and loans in its assistance to each LIC and to design non-concessional borrowing limits.

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\* The most recent upgrade to CS-DRMS software is Meridian. Meridian is currently available on a pilot basis to selected countries and was released to all clients in January 2019. Unlike CS-DRMS, the software is intended to be used for debt strategy formulation and other middle office functions.

## **DEBT SUSTAINABILITY ANALYSIS FOR MARKET ACCESS COUNTRIES**

The IMF has also developed a separate debt sustainability analysis tool for market-access countries (MACs) that typically have significant access to international capital. It involves probabilistic judgments about the trajectory of debt and the availability of financing on favourable terms.

## **MEDIUM-TERM DEBT MANAGEMENT STRATEGY TOOLKIT**

The MTDS toolkit is a spreadsheet-based analytical tool designed to assist country authorities in analysing the cost and risk trade-offs inherent in a government's financing choices. The framework seeks to help countries in the development of a DMS that (a) incorporates key linkages with macroeconomic policy; (b) is consistent with maintaining debt sustainability; and (c) facilitates domestic debt market development.

## **SOVEREIGN ASSET AND LIABILITY MANAGEMENT FRAMEWORK**

The SALM framework allows governments to examine all of the accumulated assets and liabilities that the government controls. It uses fiscal stress tests to gauge the resilience of public finances against shocks, and can reveal vulnerabilities that standard debt management analysis might miss. This is because it extends the scope of fiscal analysis beyond the standard measures of debt to include all assets, whether financial, infrastructure, or natural resources, as well as liabilities that are rarely included in government debt, such as pension obligations to public sector employees. Although data quality can be an issue, especially when looking at the broader public sector, a SALM framework can be useful even in a very constrained data environment.

## **DEBT MANAGEMENT PERFORMANCE ASSESSMENT**

The World Bank has developed a program, in collaboration with other partners, to assist developing countries in improving debt management. A cornerstone of the program is the DeMPA tool, a methodology for assessing public debt management performance through a comprehensive set of performance indicators spanning the full range of government debt management functions. The indicator set is intended

to reflect an internationally recognised standard in the government debt management field and may be applied in all developing countries. Nonetheless, the country context needs to be taken into account when evaluating a country's debt management capacity and needs. A country's needs are shaped by the capital market constraints they face, including the exchange rate regime, the quality of their macroeconomic and regulatory policies, the institutional capacity to design and implement reforms, the country's credit standing, etc. Capacity building and technical assistance therefore must be carefully tailored to meet policy goals, taking into account country characteristics.

# 15 Recording, Reporting and Maintaining Good Debt Data

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Accurate and comprehensive debt data is a cornerstone of sound public debt management. It is essential that borrowers ensure that comprehensive records of general government debt (including off-budget entities and contingent liabilities) are maintained accurately and updated on a timely basis, and that public debt reports and data are regularly made available. Sound debt recording and reporting develop credibility, confidence, and trust with policy makers, multilaterals, investors, financial markets and the general public. Governments that fail to monitor their financial liabilities may create unnecessarily high debt-servicing costs and are unlikely to be able to deliver planned services to their populations.

In this chapter, we discuss the importance of debt data in two different temporal situations: ongoing day-to-day activities and exceptional circumstances.



## Ongoing Debt Recording and Reporting

Best practice debt management requires centralised data collection and management on a consolidated basis that encompasses the entirety of the public sector. This will include the general government and all public corporations (which includes SOEs, state-owned banks and other entities). Please refer to diagram below:

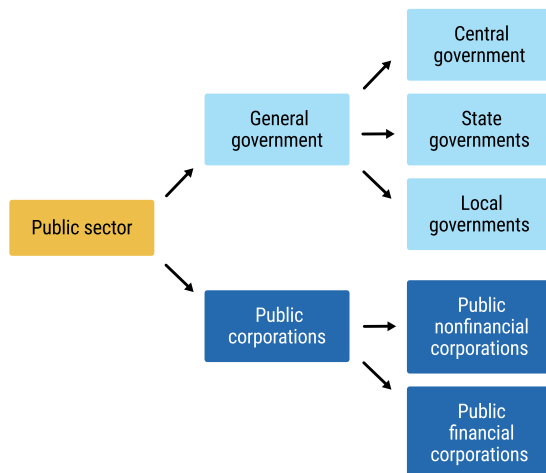


FIG.18. Coverage of public sector debt

All new indebtedness that is contracted, or any liability assumed that can have an impact on the financials of the sovereign, should be included. All governmental bodies falling on the state “balance sheet” should be reporting on a regular basis, as well as whenever a new indebtedness is contracted or any liability assumed that could have an impact on the financials of the sovereign.

The following is a sample list of usual liabilities:

- All arrangements and loans with the IMF and any other multilaterals (The World Bank Group, AfDB, etc.) .
- All local currency-denominated debt.
- All foreign currency sovereign debt.
- All hedging arrangements on sovereign debt (e.g. interest and currency swaps).

- All sovereign contingent liabilities (e.g. guarantees, indemnities, public-private partnerships (PPPs)).
- All subnational debt and subnational contingent liabilities.
- All SOE debt and SOE-contingent liabilities, social security funds and state-owned banks.
- Central bank debt and central bank contingent liabilities.

## Practicalities of Maintaining Up-to-date Records

Experience shows that many sovereign governments lack accurate-up-to-date records of the consolidated debt and liabilities. The practicalities of recording and maintaining up-to-date records are still operationally challenging to many country authorities due to the fragmentation of debt management responsibilities across several government entities, lack of high-level ownership and support for debt management, and high staff turnover in debt management units. Data on debt in several African countries suffers from substantial gaps, particularly as it relates to public guarantees and the debt owed to public sector entities outside the general government. This can result in significant underestimation of public sector liabilities, while undermining the quality of the DSA.

Countries that are beginning the process of building capacity in public debt management need to prioritise development of accurate debt recording and reporting systems. These debt management information systems should include up-to-date records of all holders of existing debt, and contingent liabilities of the bodies and agencies listed above. This depository should be in physical as well as in electronic form.

The depository should not only include the original documentation evidencing the liability, but also any supplementals and amendments, waiver requests and consents, extensions, roll-overs, notices and all other material communication to and from the underlying creditor(s). For bonds issues, this will include communications with the listing agents/stock exchanges and international clearing systems. Moreover, sound business recovery procedures should be in place to mitigate the risk that debt management activities might be severely disrupted by theft, fire, natural disasters, social unrest, or acts of terrorism.

Given that government debt issuance is increasingly based on efficient and secure electronic book-entry systems, comprehensive business recovery procedures, including robust back-up systems and controls, are essential to ensure the continuing operation of public debt management, to maintain the integrity of the ownership records, and to provide full confidence to debt holders on the safety of their investments.

While robust debt management information systems are essential for debt management and risk analysis, their introduction often poses major challenges for debt managers in terms of expense and management time. Moreover, the costs and complexities of the system should be appropriate to the country's needs. There are other infrastructure challenges which impact the public debt managers to adopt best practice policies.

## Ongoing Reporting Requirements

Each sovereign has mandatory reporting obligations to three different constituencies. These are:

1. The sovereign's legislature: Each jurisdiction usually has norms requiring regular reporting of consolidated sovereign liabilities to its parliament/congress/national assembly and other elected representatives. In certain cases, these obligations are set out expressly in public debt management statutes.
2. Multilaterals: The IMF undertakes periodic missions, normally on an annual basis, to countries to review and assess the economic and financial policies of the sovereign and prevailing trends (Article IV consultation) in consultation with ministries, central bank policymakers, and other stakeholders. As part of this consultation, the sovereign has a duty to report to the IMF on all its current and contingent liabilities, and funding plans going forward. As a result of this exercise, a comprehensive IMF staff report will be prepared, discussed with the sovereign, and presented to the IMF executive board prior to publication.
3. International investors: As part of the contracting of international financing, usually there is a requirement to regularly provide information to investors. This is also a listing requirement, where issuers are required to produce periodic reports plus extraordinary occurrences of any relevant material events. Even if it

is not contractually agreed and/or required by a listing authority, it is good practice to keep investors informed.

## Debt Recording and Reporting in Exceptional Circumstances

In times of difficulty (for example, during debt relief negotiations), creditors would normally require more intense and detailed reporting and can exert considerable pressure on the ministry of finance. A comprehensive debt review requires the data collection (if not already available) and up-to-date analysis on a time-pressured and more politically-sensitive basis. In doing so, it is important to take into account interconnected issues, bearing in mind a crisis resolution discussion with the creditors. This can be a lengthy, detailed, arduous, and protracted process. Clear national interests have to be defended, and clear-headed consideration of important questions such as financial policy, economic independence, foreign relations, and national security may follow.

This should be conducted by a high-level cross-ministerial team of officials working with a small team of external advisors (legal, financial, and communications). See also the chapter on how to select advisors and the section in Chapter “How Do I Manage Distressed Debt Situations?”.

## A Special Note on Monitoring Contingent Liabilities

There are three elements in the ongoing monitoring of contingent liabilities:

**Internal recording.** All contingent liabilities must be recorded and monitored internally by public debt managers.

**External reporting.** Contingent liabilities also need to be accounted and recorded publicly as required by applicable laws and the appropriate accounting or reporting standards.

**Management and monitoring.** By their nature, contingent liabilities are uncertain. The likelihood that any one of them may become an actual liability will vary. Public

debt managers should monitor them on an ongoing basis and by reference to various base case and adverse case scenarios. Standards to monitor contingent liabilities are still evolving (these are complex unforeseen circumstances). There is no single solution to capture all cases for all countries. Monitoring of contingent liabilities is nonetheless encouraged to enhance transparency.

If improperly monitored and managed, contingent liabilities can, in extraordinary times, have a significant negative impact on the government's debt sustainability.

### **CONTINGENT LIABILITIES IN THE CONTEXT OF THE DEBT SUSTAINABILITY FRAMEWORK**

The IMF has established guidelines for LICs in the Debt Sustainability Framework (DSF), which can give a sense of the magnitude of the potential impact of these contingent liabilities. According to the guidelines of December 2017, the assumptions for “default shocks” were as follows:

1. Debt owed by SOEs represents 2% of GDP.
2. PPPs constitute 35% of the country's PPP capital stock.
3. Financial market shocks account for 5% of GDP.

The above are only guidelines, and in general it is expected that debt managers will further tailor these assumptions based on country-specific circumstances. Based on the experience of the United States and Europe during the global financial crisis, where systemic contingent liabilities represented a significant part of the GDP, a prudent debt manager may wish to run extreme stress tests to understand the potential full ramification of a systemic crisis in their country.

Better recording and debt management systems will allow for improved control, recognition, and hedging of the underlying risks, to mitigate the crystallisation of liabilities (contingent liabilities in particular). Please refer to Chapter “Contingent Liabilities”.

# 16 Debt Management Strategy

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A government's DMS is a medium-term plan that guides borrowing decisions, taking into account cost and risk preferences and the country's fiscal and balance of payments constraints.

The DMS provides a framework within which the government can make informed choices on how best to meet financing requirements. Within that framework, once a government has approved a DMS, the public debt manager is empowered to take a disciplined approach in pursuit and implementation of the debt management objectives.

It is critical that the DMS fits into the overall medium-term macroeconomic policy framework. An effective DMS will be a result of strong coordination between the debt management unit and the relevant fiscal and monetary policy authorities (ministry of finance and the central bank, respectively).

Typically, the key objectives of a DMS are:

- to facilitate the raising of the required quantum of funding, from an appropriate mix of sources, to meet the government's financing needs.
- to minimise the overall cost of funding, consistent with an acceptable degree of risk.

- to manage the sovereign debt profile through proactive liability management.
- to ensure that payment obligations are met.

## Process for Developing a Debt Strategy

A formal DMS, once adopted by key stakeholders within the government, can help build broad-based support for responsible financial stewardship. To ensure transparency and accountability, the important features of the DMS should be communicated to key stakeholders (including legislators, local and international investors, rating agencies and the general public). It is good practice for the sovereign to review and update its debt management strategy on an annual or other regular basis, and more frequently if macroeconomic or market conditions change significantly.

One of the key inputs required for the development of a sound debt strategy is the collection of accurate data on the total amount of debt outstanding (including SOE debt and contingent liabilities) and on the terms and conditions of such debt (e.g. currency, maturity, interest rate and instrument type, governing law and use of funds).

To implement the DMS, an annual borrowing plan should be developed by the public debt manager. The annual borrowing plan should take into account the underlying volatility of the government's cash flows as well as reflect the borrowing requirements identified in the preparation of the fiscal year's budget.

As previously discussed, the MTDS toolkit developed by the World Bank and the IMF provides countries with a comprehensive and structured approach to the formulation of a debt strategy. The key steps to be followed are:

1. Identify the objectives and scope of public debt management. The relevant objectives for debt management are often framed in terms of ensuring that the government's financing needs and payment obligations are met on a timely basis, and at the lowest possible cost, consistent with a prudent degree of risk. A secondary objective can be supporting domestic debt market development.
2. Identify the current DMS and analyse the cost and risk of the existing debt stock.

3. Identify and analyse potential funding sources, including associated costs and risk characteristics, prevailing market conditions, and existing exposure to any particular source of funds.
4. Prepare a DSA reflecting baseline macrofinancial assumptions of the government and various funding options. This phase will require close interaction with the relevant fiscal and monetary policy authorities.
5. Identify preferred funding options and discuss with fiscal and monetary policy authorities in order to secure consensus. Based on feedback, the debt manager may have to submit an alternative proposal for approval.

## Debt Strategy and Development of Domestic Debt Markets

African issuers have funded themselves in foreign currencies as a result of the limited depth of the domestic financial markets. African issuers have therefore been forced to fund themselves in foreign currencies without corresponding increases in foreign exchange inflows.

This is a cause for concern since high levels of foreign-currency debt exposure increase a sovereign's vulnerability to refinancing and exchange rate risks.

Strengthening domestic debt markets can help mitigate these risks and provide a stable source of long-term financing. Domestic markets also have an important role to play in mobilising private capital to finance domestic developments. At the same time, domestic government bond markets create tools to manage macroeconomic and fiscal risks and provide pricing benchmarks for local companies.

Several African countries have made progress in issuing local currency denominated debt and developing domestic financial markets, yet much more needs to be done in this respect across the continent. The DMS can help identify key institutional challenges in developing local debt markets, and can help address these challenges.



## Costs and Risks of Potential Sources of Financing

When designing the debt strategy, a public debt manager has a variety of available financing options to consider which can include the following \*:

1. **Concessional loans** - Concessional debt instruments provided by multilateral and bilateral lenders often have a long maturity, long grace periods and below-market interest rates. Because of these characteristics, concessional loans are usually the most attractive source for debt financing for development expenditures. However, there are potential constraints to be considered by the debt manager as these creditors often set specific conditions before loans are disbursed. Multilateral creditors may either constrain the use of funds to specific purposes or set other policy-related conditions. In terms of bilateral loans, these conditions could include requiring recipients to use or procure goods and services exported by the creditor country.
2. **Local currency denominated debt** - An increasing number of sovereigns have been issuing local currency denominated debt which does not increase the sovereign's foreign currency debt stock. The nature of the country's domestic investor base will determine the capacity of the domestic market to absorb the quantum and the desired range of debt instruments. To date in most African countries, the majority of this debt has been subscribed by international investors as the domestic financial markets are not sufficiently developed. As a result, the stability of such capital flows is subject to changing market sentiment, particularly in situations of currency depreciation risks. In addition, the maturities of local currency denominated debt instruments are generally shorter than those available for foreign currency denominated instruments. Interest rates on local currency denominated instruments tend to be higher. The shorter maturity of these financings and the volatility of the international investor base increase the government's refinancing risks. Furthermore, there is a risk that

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\* Grants from international donors and bilateral official partners are the most attractive source of government financing as they do not need to be repaid. However, neither do they contribute to the growth of debt stock.

excessive government borrowing from local banks and financial institutions will “crowd-out” lending to other local companies and entrepreneurs that is needed to stimulate economic growth.

3. **International debt** (e.g., bonds and syndicated loans) - International debt markets provide another source of non-concessional financing. Compared with the context of concessional financing, the use of proceeds is not closely monitored. Although the international debt markets offer the deepest and most liquid sources of financing, the accumulation of large volumes of foreign currency non-concessional debt can pose serious exchange rate and refinancing risks to a sovereign debtor. Sovereign issuers should be aware that smaller-sized bond issuances result in lower secondary market liquidity and tend to have less attractive financial terms. Innovative bond issuance structures have been recently developed in Africa that include either partial guarantees from multilaterals (such as the World Bank and the AfDB) or insurance provided under the aegis of the Africa Trade Insurance, or both. These innovations have enabled some African countries to tap international capital markets on more favourable terms.
4. **Structured financing alternatives** - some sovereign debtors not have access to the international debt markets. This may be for a variety of reasons. In these cases, a public debt manager may examine more complex, structured instruments. These instruments may include oil-linked and other commodity financing structures, repurchase transactions relating to gold and other available assets, and collateralised and loan participation note structures. While these financing tools may be available to address short-term liquidity problems, they are typically complex, expensive and non-transparent. They can sometimes give rise to policy concerns from the IMF, the World Bank and other multilateral partners, for example as a result of concerns about transparency, debt-sustainability and compliance with the World Bank negative pledge. Furthermore, should a restructuring of these arrangements ever be required, they can be difficult and costly to unwind.



# Role Of Advisors



## *Key Points*

*Independent, professional advisors for financial, legal and communications assignments play a critical role in assisting the government achieve its objectives.*



*Advisors should be engaged at the earliest possible opportunity - and kept close/informed.*



*Advisors can assist in normal times but also in crisis situations. Their vast experience in similar circumstances can be very beneficial for sovereigns facing difficulties.*



*An important aspect for the sovereign is to develop its own capacity, based on know-how from its team of advisors and international best practices.*



# 17 Who Can Help Me And Why Do I Need Them?

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## Independent Professional Advisors

Governments have access to myriad technical assistance programs from multilateral institutions, through good and bad times. However, such programs essentially aim to build the capacity of government employees and therefore should not be viewed as a replacement for independent, professional advisors for financial, legal and communication advisory assignments.

### Financial Advisors

International financial advisors are professionals with deep expertise in macroeconomic and financial issues faced by sovereigns. They have accumulated experience working for several countries in a variety of regions around the world, and can draw on both lessons learned and global best practices.

There are several independent firms that specialise in providing macroeconomic and financial advice to sovereigns. Some are known for their regional focus, while others have a more global practice and may at times partner with qualified local non-conflicted experts with in-depth knowledge of the local market and political and economic environment. Financial advisors can perform a range of functions to assist ministry of finance officials, debt management offices (DMOs) and central bankers.

The figure 19 summarises the main functions of the financial advisors:

## Legal Advisors

Legal advisors are reputable international law firms (or experienced legal consultants) specialised in providing best-in-class advice to sovereign governments on a range of legal and strategic matters, including but not limited to debt financing, the regulatory framework, legal risks, liability management and litigation. There are several global firms that have well-known sovereign advisory practices, and they may partner with locally-qualified correspondent legal firms as needed.

## Financial and Legal Advisors in Debt Restructuring Situations

Appointed financial and legal advisors are an integral part of the government's team responsible for the sovereign's negotiations with multilateral (including the IMF), bilateral and private creditors. It is important to note that legal and financial advisors are working exclusively for the long-term benefit of the client country.

Legal and financial advisors will often act as an important interlocutor between the sovereign team and the relevant IMF team, particularly when the country is in an IMF-supported Programme. Depending on the scope of work this may include the following:



1. the financial advisors can assist the sovereign to engage with the IMF on the assumptions underlying the debt sensitivity analysis (DSA), which determines the amount of debt relief required to put the debt on a sustainable basis with a high degree of probability;
2. the legal advisors will assist on the analysis of the legal risks, development, and evolution of legal strategy;
3. the financial and legal advisors will work together on a coordinated strategy for engaging with the creditors.

The figure 20 illustrates the joint role of financial and legal advisors in debt-restructuring situations.

## Communications Advisors

In addition to financial and legal advisors, sovereigns may consider hiring advisors that specialise in media and communications. They will work with the sovereign in coordination with the financial and legal advisors to ensure a sound, effective, transparent and credible narrative around the country's macroeconomic and financial strategy, development plans, financing required, or debt relief as part of its restructuring strategy. Communications advisors will assist in better reaching out to:

1. Internal government officials (other ministries, parliament/congress/national assembly, other government stakeholders, etc.)
2. Domestic stakeholders (domestic investors, non-governmental agencies, and most importantly, the population, etc.)
3. International investor and financial community (development partners and donors, current and potential foreign investors, credit analysts, etc.)



## FINANCIAL ADVISORS: WHY DO I NEED THEM?



### Sustainability

to assist the sovereign in defining the country's medium term (4 years) macrofinancial framework to ensure sustainability.



### Funding strategy

to assist the sovereign in defining and managing an optimal funding strategy with a view to mitigate "risks"



### Market access

to assist the sovereign in assessing market access (sources of funding, optimal maturities profile and financial conditions, yield curve objectives, etc.).



### Liability Management

to assist a sovereign in implementing appropriate liability management strategies to better manage risks.



### Optimal Credit Rating

to assist the sovereign in securing optimal sovereign credit ratings.



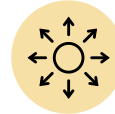
### Communication

to assist the sovereign in communicating to their domestic constituencies and international financial and investor community the strategy and vision for the country.



### Coordination

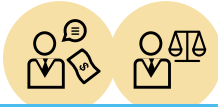
to assist the sovereign in coordination with multilateral institutions towards creating appropriate debt management offices and defining their functions.



### Capacity Building

to assist the sovereign in transferring macrofinancial and debt management expertise to debt managers in normal times, in debt crisis and post-crisis.

FIG.19. Functions of financial advisers



## THE JOINT ROLE OF FINANCIAL AND LEGAL ADVISORS IN DEBT RESTRUCTURING SITUATIONS



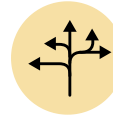
### Perimeter determination

to assist the sovereign in identifying the perimeter of debts to be included in the restructuring and who the creditors are.



### Identifying key players

to assist the sovereign in identifying constructive non-official creditors with whom to enter into dialogue towards reaching a consensual restructuring.



### Assessment of options

to assist the sovereign in preparing a menu of restructuring options reflecting the overall amount of sought debt relief.



### Pre-empting difficulties

to assist the sovereign in identifying potential holdout situations and legal techniques to address such situations.



### Communication

to assist the sovereign in devising the appropriate communication strategy.

FIG.20. The joint role of financial advisors in debt restructuring situations

# How to choose? Best Procurement Practices for the Selection of Advisors

Procurement rules are aimed at ensuring that the selection process is competitive, fair, and transparent, and that it aims for the selection of experienced and reputable advisors.

Any procurement process should consist of five parts, as outlined in the following diagram:

Following the bidding period, all proposals should be reviewed, taking into account the expertise and track record of the proposed advisors in similar advisory situations, the advisor's proposed methodology in providing the required services, and the costs of the services, all of which need to be appropriately balanced in order to identify the most optimal advisor to the government.

Beyond the skills of the advisors and the cost of services, in reviewing bids, the reviewer must also take into account conflicts of interest. As it is broadly defined, a conflict of interest exists where there is a divergence between the advisor's self-interest and the interest of the government procuring the services.

Any conflict of interest should be examined in detail, and parameters should be set by the government regarding which conflicts are acceptable and can be waived, and under what conditions, and which conflicts can never be waived.

Further, while there are many institutions – big and small – and individuals who offer the service of acting as financial and legal advisor, there are only a handful of firms that specialise in providing independent financial and legal advice to sovereign governments. In this context, it is often the best course of action to seek and obtain the advice of a neutral, independent advisor, such as certain multilaterals, before proceeding to engagement. For example, the African Legal Support Facility (ALSF), is dedicated to procuring, engaging and funding legal and technical assistance for African sovereigns. African sovereigns may always reach out to the ALSF for support in selecting and financing their legal and financial advisors.

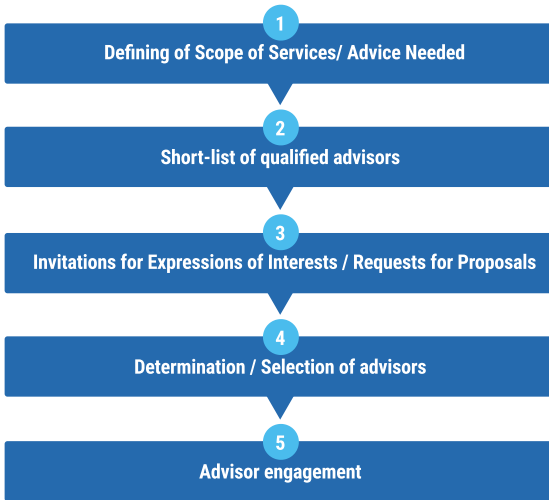


FIG.21. Procurement process

# Debt Distress



## *Key Points*

*Sovereigns need to act quickly and address any risk of debt distress as soon as it arises.*



*There are a number of signals that indicate that a sovereign may be heading towards a distress situation. These are indicative but should not be underestimated or overlooked.*



*Once the crisis has been acknowledged by country authorities, a timely and orderly assessment and resolution is required.*



*The critical steps to be considered include: (1) early involvement of advisors; (2) approaching the IMF and conducting a debt sustainability analysis, with the assistance of the financial advisor; (3) determining the volume and perimeter of the debt; (4) developing a resolution strategy tailored to the nature of the crisis (liquidity v solvency); and, (5) establishing a comprehensive communications strategy to gain necessary support from different parties.*



*Different types of creditors require different strategies, based on their lending policies and frameworks.*



*The possibility of unwanted surprises lingers around these exercises and careful attention should be paid to systemic implications and the possibility of litigation.*







# 18 The Need for Timely Intervention

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The precise point at which a sovereign debtor must start taking urgent steps to address a growing threat of debt distress will differ from one situation to the next. While early warning signals may suggest the emergence of a problem early on, at a certain point there will likely be a significant disruption in a sovereign's debt management strategy that will make it imperative to confront the threat and start making strategic decisions.

Monitoring of signals and timely recognition of growing distress is critically important since, often, the impact of an evolving crisis can be mitigated through early, decisive action. On the flip side, failure to recognise the need to take urgent action has been shown time and again to exacerbate the effects of a debt crisis, increasing the ultimate cost for all actors, sovereign, public and private.

## Recognising the Evolution of a Crisis

Even where there is not a full loss of market access, (i.e. the sovereign is not able to issue any debt securities or access lending in the market), it may be the case that a

sovereign debtor finds that the cost of refinancing its debt in the local or international debt markets has spiked to levels which - in light of the debtor's specific circumstances - are unsustainable in the medium or long term. For example, investors may only be prepared to extend short-term credit at high interest rates or on onerous secured terms. The temptation of a sovereign debt manager and other government officials will be to see this as a temporary problem that will alleviate as time passes. However, experience shows that such situations are rarely temporary, and the sovereign should proceed to take concrete and timely steps to address the causes of the market disruption before the crisis deepens.

## Signals to Keep on Your Radar

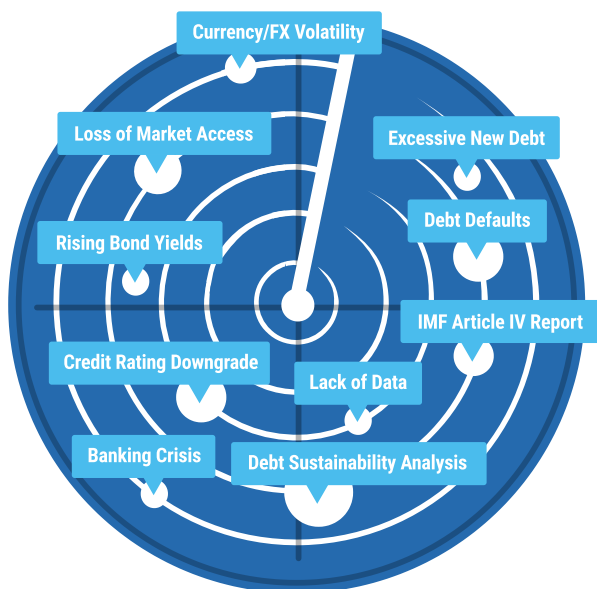


FIG.22. Signals to keep on your radar

There are a number of signals that indicate that a sovereign may be heading towards debt distress. Although the causes and severity of distress may vary, certain signals should be monitored by all prudent debt managers. These include signals that are directly monitored by debt managers in the context of the debt sustainability analysis, as well as those from rating agencies, investors, lenders, multilaterals and other stakeholders. Any information asymmetry between the assessments from the sovereign, multilateral institutions, credit rating agencies and the market, may further complicate a distress scenario.

The following is a brief summary of possible signals of debt distress:

- **Currency Devaluation/Declining FX Reserves:** A currency devaluation or rapid decline in FX reserves, relative to the composition of the sovereign's debt stock or trade balance, may be a signal of debt distress and lead to or reflect a loss of international confidence in the management of the economy.
- **Deteriorating Debt Market Access:** Falling demand for a sovereign's local currency or FX-denominated debt in local or international debt markets is a signal for potential distress as it indicates that investors are not willing to put additional capital at risk. Often this arises when a sovereign is seeking to roll-over or refinance maturing debt facilities.
- **Bond Yields:** Falling bond prices, and the inverse increase in yields, can serve as a signal of a rapid shift towards distress since ratings agencies may reclassify the bonds as having “junk status”, which in turn will cause many institutional investors to sell those bonds because they do not meet credit quality requirements of their portfolios.
- **National or IMF/ World Bank Debt Sustainability Analysis (DSA):** Significant shifts in the periodic analysis of the sovereign's ability to service its external and overall debt, based on indicative debt burden thresholds and international benchmarks, is one of the most reliable signals of distress. This analysis will typically be part of a DSA by the sovereign's debt managers and/or the IMF/ World Bank. Other reports by these institutions will be considered by virtually all market actors in their debt analysis. IMF / World Bank reports, including the regular Article IV, include a review of risks such as exchange rate volatility; monetary, fiscal, and regulatory policies; the stability of the banking system, exports and trade deficit; tax mobilisation; overall debt sustainability risks, and general challenges facing the country.

- **Credit Rating Agencies (CRA):** A CRA's issuance of a negative watch or downgrade of a sovereign's credit rating is a strong indicator of distress as CRAs follow transparent and well-known criteria in their risk assessments. This signal may be more intermittent as CRAs typically only issue guidance following a significant event or on a regular interval (typically 6 months).
- **Default on a Sovereign's Debt Contracts:** The occurrence of an event of default under one or more sovereign debt contracts is a strong indicator of potential distress, because it may enable creditors to demand early repayment or exercise other remedies. Even if the default is rapidly remedied before creditors have reacted, debt managers should see the default event as a sign of increasing distress risk, especially since market actors will view the event as a precursor to greater financial instability.
- **Banking System Crisis:** There is an old adage in the world of sovereign debt restructuring – "never let a sovereign debt crisis become a banking crisis, and never let a banking crisis become a sovereign debt crisis." Even a sovereign with a positive debt outlook may be severely impacted by a crisis or collapse in its domestic banking system due to the potential for the sovereign to intervene by recapitalising banks or assuming liability for distressed assets.
- **Rapid Accumulation of New Sovereign Debt:** New levels of borrowing that exceed the sovereign's medium-term economic growth potential and corresponding debt-servicing capacity can also be a signal of impending debt distress. Even though the small group of lenders behind the borrowing may believe that the sovereign can service the debt, the broader market may have reached a general consensus as to whether the newly accumulated debt has shifted the sovereign into an unsustainable position.
- **Insufficient Historical Data:** The absence of historical recording of and data for government debt, including non-financial public sector debt and loan guarantees, should serve as a signal of distress for newly appointed debt managers because it implies the prior debt accumulation and/or debt strategies were driven by uninformed decision making.

# 19 How Do I Manage Distressed Debt Situations?

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## The Team and The Plan

The management of a distressed situation requires a strategy team and a plan. Difficulties will always be resolved better and faster where the team leading and managing the sovereign's efforts is well prepared. This should be the first step in the handling of the crisis. The sovereign and its leaders should not delay in taking these steps. Denial of the problem and prevarication in its resolution will only exacerbate the difficulties and will increase the inevitable dead weight losses which the crisis will bring.

The team, likely to be established on an *ad hoc* basis at the sovereign's ministry of finance, will need to have the resources and the support to be able to deliver on the tasks ahead. Its members must have both the expertise and the authority to design, decide, and implement the solutions. Government departments, central banks, debt managers, and state-owned enterprise (SOE) managers should be ready to work together and assist the team.

## Action Plan

When faced with difficulties in their debt management, sovereigns will need to undertake a series of actions in order to facilitate a timely and orderly assessment and resolution. First, in consultation with advisors and multilateral institutions such as the IMF and the World Bank, the sovereign will need to assess the severity of debt distress and its causes and prepare an updated DSA to determine what interventions will be necessary. That consultation will also include a determination of the outstanding debt and any imminent debt payment obligations. Based on this analysis of debt amounts and debt payments, the sovereign should then establish the perimeter of debt to restructure and develop a resolution strategy. Finally, the sovereign needs to assess the potential systemic implications of this distress resolution strategy (e.g. for the banking sector) and the required political support to adopt and implement the difficult policy decisions needed. Although this process may be complex and difficult to manage, a transparent and orderly resolution of debt problems can avoid unnecessary delays and reduce potential pitfalls with serious social implications.

## Pitfalls to Avoid

There will often be political and other pressures imposed on sovereign debt managers and responsible government officials to delay necessary — but painful and unpopular — measures to address a debt distress. The steps taken in an effort to avoid taking these difficult decisions often themselves exacerbate the problem. Examples of poor practice in managing a sovereign debt crisis include: (1) providing bilateral creditors with access to strategic state resources or assets in return for bilateral lending commitments; (2) forcing domestic pension funds to invest a percentage of their portfolio in sovereign debt; (3) requiring local banks to extend credit lines to the government on non-commercial terms; and/or (4) conducting fire sales of state assets to raise cash for repaying debt.

# Routine vs. Distress Debt Management

It is important to differentiate between the normal course of debt management, which is a routine operation for sovereigns, from a distress scenario. As a result of domestic or international market disruptions, a sovereign may be subject to a short-term liquidity challenge which may deviate from its existing debt management strategy (DMS). In a short-term liquidity situation, the economy of the sovereign remains healthy, its macroeconomic policies are well suited to the country, and the sovereign is expected to generate sufficient revenues to meet its financing needs in the medium and long term. Because of this positive outlook, market actors will not perceive this as a debt distress situation but as a temporary liquidity shortage. In this situation, a sovereign may deploy standard liability management tools, such as bridge financing, exchange offers, or rollovers. For additional insight into debt management, refer to the Chapter “Debt Management Strategy”.

## Debt Distress

In the sovereign context, debt distress is a more persistent financial disruption that results from the market's lack of confidence in economic policies and outlook. This financial disruption leads to a loss of access to the market, causing a balance of payments problem because the sovereign is no longer able to borrow to meet its needs. As a result of this more challenging outlook, the sovereign cannot simply rely on deploying its own liability management tools but will instead need to engage in a more detailed analysis to determine the magnitude of the problem, often with the support of advisors and multilateral institutions such as the IMF and the World Bank.

The sovereign will then need to consider covering its financing gap. If possible it may wish to approach friendly donors and development partners for grants and/or concessional financing. In more extreme circumstances, the sovereign may then be required to approach the IMF and other multilaterals for financing and/or seek relief from its creditors in order to remedy its inability to meet its debt obligations. The form of creditor relief may vary from renegotiating of maturities (reprofiling) to fundamental restructuring of debt obligation (restructuring), and in either case, the



sovereign will need to have adopted a resolution programme that provides creditors with the confidence that relief will allow the sovereign to exit the distress scenario.

We set out below a general overview of the consultation, assessment, and resolution process in a distress scenario.

## Consultation

There comes a point where it is evident a sovereign is facing a situation of debt distress. In this situation, a sovereign debt manager should take two immediate steps to begin to assess the problem and potential solutions:

### **APPOINTMENT OF EXTERNAL ADVISORS**

Experienced financial and legal advisors should be hired without delay in order to help the sovereign assess its financial and legal options. These advisors should be experienced in sovereign debt restructuring so as to be able to support the sovereign in navigating the forthcoming restructuring process. Delaying the appointment of such advisors can make it difficult for a sovereign debt manager to respond to a rapidly evolving situation in an optimal way. Refer to the chapter “The Role of Advisors” for a detailed discussion.

### **APPROACHING THE IMF**

The sovereign should approach the IMF for help in evaluating the options available to it for addressing the debt crisis. The type of IMF financial assistance that may be available to the sovereign in this situation, and the conditions for provision of such assistance, will depend on the outcome of the IMF's debt sustainability analysis. If the IMF determines, based on the DSA, that the sovereign's debt is unsustainable, then the IMF cannot provide financial assistance to the sovereign debtor unless the sovereign is taking credible steps - in the view of the IMF - to restore sustainability. It would be up to the sovereign to decide whether to restructure its debt. It will be a condition for the IMF providing financing to the sovereign in this situation that the IMF believes these steps are being taken. However, such financing can be provided before a debt restructuring is completed, so long as the IMF has confidence that a credible process for restructuring is under way, and that the restructuring will result

in high creditor participation to restore sustainability. IMF financing will be subject to the satisfactory implementation of these steps.

If the DSA indicates that the sovereign's debt is sustainable, then the IMF may provide financing support to the sovereign without requiring debt restructuring. In those cases, a combination of agreed policy adjustments and financing, including any from the IMF and bilateral creditors, is normally sufficient to preserve debt sustainability.

In either case, the sovereign and the IMF will need to develop a macroeconomic framework that includes the overall financing envelope, parameters and conditions of IMF financing, including fiscal and structural adjustments that the sovereign must undertake. This framework will guide the negotiations between the sovereign and its creditors, as may be required under the circumstances. The IMF can provide financing in a pre-default or post-default context, subject to certain conditions. In the post-default scenario where the sovereign has accumulated arrears to multilaterals, bilateral and/or private creditors, it can only do so if certain conditions are satisfied under the IMF's arrears policies.

Where a sovereign is not in need of immediate IMF financial assistance, it is possible for it to negotiate a debt restructuring with its commercial creditors (but not its Paris Club creditors) without the anchor of an IMF-supported program. However, this is generally a lengthier and more complex process because the requested restructuring effort is not underpinned by an IMF-supported adjustment program.

## Strategy Development

Having appointed legal, financial and communications advisors, and consulted the IMF to determine the nature and terms of the financial assistance that may be available to it, the sovereign debtor should then take three steps as precursor to implementation of a necessary debt restructuring operation: (1) define the perimeter of sovereign debt to be included in the forthcoming debt restructuring operation; (2) assess the sovereign's litigation risks and asset protection priorities and (3) agree on a communications strategy with creditors and other stakeholders.

## **RESTRUCTURING PERIMETER**

A very important step for the sovereign is to define the perimeter of the debts to be restructured. A very important step for the sovereign is to define the perimeter of the debts to be restructured. The perimeter needs to be informed by the financing envelope defined under the IMF-supported programme. It is advisable that the sovereign attempt to define the widest possible debt perimeter in order to maximise debt relief and ensure inter-creditor equity.

Careful consideration should be given to the categories of debt which will not be included in the restructuring. Any category of debt or creditor not included the restructuring should only be done on the basis of generally accepted legal principles and international best practice, and without materially compromising the goals of debt relief maximisation and equal treatment of creditors.

In the debt identification exercise, the sovereign should determine the appropriate treatment of the various categories of debt with the relevant creditors. The design needs to ensure inter-creditor equity so as to achieve high participation in the restructuring.

## **LITIGATION RISKS AND ASSET PROTECTION**

Commercial creditors will sue on sovereign debt to recover their claims. Distressed debt investors, in particular, have shown little hesitation in pursuing sovereign debtors. In most cases, it is straightforward to obtain a debt judgment on the non-payment of contracted sovereign debt. However, enforcing it is a completely different story.

Although the litigator's imagination has no boundaries, the sovereign usually does not have many attachable assets abroad and should take steps to protect those overseas assets. Even those few assets that are located abroad, such as diplomatic missions, payments to and from international financial institutions (such as the IMF) and military assets, usually enjoy immunity from any enforcement action. As previously mentioned, care should be taken by the sovereign debtor with the support of its legal advisors — when the debt is initially being documented — to ensure that overseas assets of national importance or particular sensitivity are expressly excluded from possible enforcement or attachment action by the creditors.

It is essential in crisis management for the government to assess, with the assistance of its legal advisors, which are the “vulnerable” non-resident assets of the sovereign (e.g. foreign exchange reserves/deposits/assets owned by the central government and SOEs located outside the jurisdiction) and conduct a proper analysis of the legal risk of attachment of such assets by judgement creditors. This involves an analysis of the protections afforded by principles of sovereign immunity for state assets in the jurisdictions where the assets are located.

## **COMMUNICATIONS AND OUTREACH STRATEGY**

Once the perimeter of the debt restructuring operation has been established, it is important for the government or authorities to determine and implement, with input from legal and financial advisors, an effective external communications strategy to create an environment conducive for a constructive resolution of the debt situation. Specifically, it is important that the government convey clearly and consistently its objectives in the debt-restructuring process, including the constraints (sometimes set under IMF-supported programmes) under which it is operating.

# Identifying the Nature of the Distress

Having determined the perimeter of the debts to be included in the restructuring, identified relevant litigation risks and agreed a communications strategy, the sovereign debt manager and its financial and legal advisors will then move forward with implementation of the needed debt- restructuring operation. The precise nature of the operation will largely be guided by the outcome of the IMF DSA, and, more specifically, whether the sovereign is considered to be facing a liquidity crisis or a debt-sustainability crisis.

## Liquidity Crisis

In this scenario, the sovereign is unable to service its debt, principally due to liquidity constraints. In essence, the country's available liquid assets are insufficient to meet its maturing debt obligations, and it is unable to roll over its debt obligations with

creditors due to loss of market access. However, as noted above, the debt is not considered unsustainable. Accordingly, the sovereign has a good prospect to regain market access upon implementation of appropriate macroeconomic policy adjustments over the medium term. Even with the IMF, bilateral or other multilateral financial assistance previously described, the sovereign may decide it is necessary to seek a consensual “reprofiling” of some or all of its outstanding debt with official and/or private sector creditors. The objective of reprofiling will be to extend maturity dates and/or adjust interest rates to provide space for the implementation of the needed macrofiscal policy adjustments.

## Sustainability Crisis

In this scenario, the outcome of the IMF's debt sustainability analysis is that the sovereign's debt is unsustainable. The country will be unable to meet the present value of its debt obligations without indefinitely accumulating debt. The sovereign will not only have lost market access and thus be unable to roll over its maturing debts, but will likely be experiencing an acute balance of payments problem as well. To address the balance of payment problem, the country will need to obtain new financing (including from the IMF) which will require the sovereign to undertake a debt-restructuring operation aimed at restoring debt sustainability. In order to develop a successful debt-restructuring plan, the sovereign will need to determine, in consultation with its financial and legal advisors, the appropriate strategy for restructuring some or all of its outstanding debt with official and/or private sector creditors.

## Techniques of Debt Restructuring

Once the sovereign determines that it is necessary to restructure some or all of its debt, whether to address liquidity or sustainability concerns, it will need to develop a restructuring strategy tailored to the characteristics of the affected creditor categories.

## Paris Club Creditors

The sovereign may decide to approach the Paris Club to seek rescheduling of its government-to-government debt to Paris Club creditors. For additional background on the structure and methodology of the Paris Club, please refer to the Chapter “Bilateral Creditors”. The precondition for a Paris Club rescheduling is that the country must have an IMF-supported programme in place. The Paris Club has established a menu of options for sovereign debtors in debt distress, referred to as different “treatments”. These options include rescheduling, which is debt relief by postponement of maturities or, in the case of concessional rescheduling, reduction in debt service obligations during a defined period (flow treatment) or as of a set date (stock treatment). The modality of debt treatment, cut-off date, and consolidation period depend on the financing gap identified in the IMF-supported programme. In deciding debt treatment, the Paris Club takes into account the country’s past track record, both on servicing its debts and its performance under an IMF-supported programme, and the contribution expected from other external creditors (private creditors, and non-Paris Club official sector creditors).

### Paris Club Principles

#### **Solidarity**

All members of the Paris Club agree to act as a group in their dealings with a given debtor country and be sensitive to the effect that the management of their particular claims may have on the claims of other members.

#### **Consensus**

Paris Club decisions cannot be taken without a consensus among the participating creditor countries.

#### **Information sharing**

The Paris Club is a unique information-sharing forum. Paris Club members regularly share views and information with each other about

the situation of debtor countries, benefit from participation by the IMF and the World Bank, and share data on their claims on a reciprocal basis. In order for discussions to remain productive, deliberations are kept confidential.

### **Case by case**

The Paris Club makes decisions on a case-by-case basis in order to tailor its action to each debtor country's individual situation. This principle was consolidated by the Evian Approach, a practice to discuss a debtor's situation with private creditors prior to the Paris Club meeting.

### **Conditionality**

The Paris Club only negotiates debt restructurings with debtor countries that need debt relief. Debtor countries are expected to provide a precise description of their economic and financial situation, have implemented and be committed to implementing reforms to restore their economic and financial situation, and have a demonstrated track record of implementing reforms under an IMF-supported programme.

### **Comparability of treatment**

A debtor country that signs an agreement with its Paris Club creditors should not accept from its non-Paris Club commercial and bilateral creditors any terms of treatment of its debt which are less favourable to the debtor than those agreed with the Paris Club.

The sovereign debtor and its Paris Club creditors will reach a consensus reflecting the IMF DSA, and such consensus is documented through an Agreed Minute. Completion of the restructuring process requires the subsequent signature of bilateral agreements with each Paris Club creditor country to implement debt relief no less favourable to the sovereign debtor than what is contemplated in the Agreed Minute. The Agreed Minute imposes on the sovereign debtor a comparability of

treatment obligation to conclude agreements with each of its non-Paris Club creditors on no less favourable terms.

## Non-Traditional Bilateral Creditors

As mentioned previously, an important and growing source of financing for African countries are non-traditional bilateral creditors. Since these bilateral creditors do not yet have an established framework or forum for debt restructuring - and to date have chosen not to join the Paris Club - the debtor country might experience additional challenges in dealing with these creditor countries in a restructuring scenario.

## Domestic Bondholders

Domestic investors in sovereign bonds, irrespective of currency denomination, often consist of domestic banks, pension funds and insurance companies. Careful consideration needs to be given to the potential consequences when deciding whether to restructure bonds held by these institutions. These consequences may include an adverse impact on banking sector stability and on the viability of pension funds and insurance companies, which may further affect domestic political economy.

## Non-Resident Bondholders

Bondholders' diversity makes coordination difficult for the sovereign and can challenge the possibility of reaching a restructuring agreement (or at least delay it). Individual creditors may be incentivised not to participate in the restructuring in the hope of recovering payment on the full contractual claims (holdouts). However, the sovereign can rely on collective action clauses (CACs) to address the holdout problems. With assistance of legal and financial advisors, the sovereign needs to decide whether to negotiate with a formal or ad hoc creditor committee, or a few individual large creditors who will be willing to engage in, and potentially publicly endorse, a debt resolution exercise. It is important to note that the modality of engagement should remain flexible with the aim to achieving a fair restructuring in a reasonable timeframe in the context of good faith negotiations. Where the debt



securities being restructured include publicly-traded and listed bonds, the sovereign needs to be alive to issues relating to the selective sharing of material non-public information (MNPI) with creditors in the course of negotiations. Legal advice needs to be taken to ensure the sovereign at all times complies with its duties with respect to MNPI under applicable securities regulations.

The market has developed tools to mitigate the collective action problem and enable broad creditor participation. Restructurings are now usually structured as voluntary debt exchanges. These effective “liability management” debt exchanges are facilitated by a number of techniques. These tools and techniques include:

1. CACs which allow a qualified majority of bondholders to bind all bondholders to modification of key bond terms.
2. Exit consents which allow a majority of bondholders to modify the non-payment terms (e.g. sovereign immunity, governing law, listing of the bonds, etc.) of old bonds that are being tendered in a voluntary exchange offer forcing other bondholders to participate in the restructuring or facing the prospects of ending with less attractive bonds.
3. Minimum participation thresholds designed to assure creditors that the debtor would only proceed with the debt exchange if a qualified majority of creditors decide to participate.
4. Contractual enhancements granting better protection for creditors (e.g. principal reinstatement, mandatory pre-payments, financial covenants, etc.).
5. Credit enhancements such as upfront cash repayments, cash-equivalent notes and add-ons to the new instruments (e.g., GDP-linked warrants or commodity-linked value recovery rights).
6. Regulatory sweeteners (e.g. tax benefits, beneficial liability treatment for regulatory capital, lenient treatment of defaulted obligations in insurance companies, etc.).

## London Club

London Club refers to private sector creditors to the sovereign (and, where applicable, any of the entities guaranteed by the sovereign) under private bilateral or syndicated loans almost always governed by non-domestic law. The reference to “London” is historic and was selected to juxtapose the private sector nature of these

creditors, who used to be mostly based in London, from the official sector lenders of the "Paris Club".

As the rights of London Club creditors benefit from non-domestic law, restructuring of their debt will have to be done on a voluntary basis and will require the consent of each one of them, unless any of the syndicated loans allow for the relevant changes to be done by majority vote.

The willingness of the London Club creditors to agree to a restructuring will depend (in addition to the overall offer of the sovereign to its creditors and the viability of the restructuring plan) on the nature of the lenders, their ability to absorb losses, the tax treatment of these losses, their interest in being returning players in the economy of the sovereign, and so on.

In the case of syndicated loans, the sovereign should approach the syndicate agent to negotiate a restructuring of commercial loans, which may follow a set of best practices or principles accepted in market. The restructuring generally requires the consent of each lender in the syndicate, unless loan documentation allows for the relevant changes to be made by a qualified majority vote.

## A Note on Odious Debt

Odious debt, though occasionally referenced by civil society, is not a recognised legal principle under international law. As such, a sovereign cannot rely on this principle to repudiate its debt obligations.

# 20 Recovery and Resilience

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## Recovering Sustainability

Falling borrowing costs, recovery in bond prices, increased investor appetite, and improvement of any other previously negative signals are likely to indicate that the sovereign's debt management and/or restructuring strategy has succeeded. However, as with the initial risk analysis, the sovereign should be careful not to interpret a temporary improvement in financing conditions as an indication of long-term recovery. The sovereign should continue to conduct its own sustainability analysis and consult with multilateral development banks, the IMF and creditors to confirm whether its own perception of recovery is shared by key actors in the domestic and international markets.

# Realising Resilience

A debt crisis is a very painful shock, the political, economic and social consequences of which cannot be underestimated. It is generally a humbling and expensive experience that the sovereign and its citizens will desire never to repeat.

The shared recognition of the economic disruption caused by a sovereign debt crisis often provides the sovereign with a window of opportunity to build resilience against the next challenge. There is an old adage — “never let a good crisis go to waste”. At the policy level, the government may be able to overcome political resistance for unpopular reforms, including rationalisation of public subsidies, reduction of fiscal deficits, and more rigorous execution of capital expenditure programs. The government may also seek to improve its macroeconomic management through updating fiscal rules and debt management guidelines. The government should also adopt a comprehensive communications strategy to encourage continuous feedback on its debt strategy from domestic stakeholders, the international financial and investor community, and multilateral institutions.

Following a crisis, the sovereign's near-term goals should be to restore international credibility and regain access to the market to finance its needs so as to continue driving economic growth. These short-term goals can be achieved in a manner that helps avoid repeating the same mistakes, and may even improve investor confidence in the long-term as the market recognises that the sovereign has converted wistfulness to wisdom.

# Acronyms

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ADB Group	African Development Bank Group
ADF	African Development Fund
AfDB	African Development Bank
BITs	Bilateral Investment Treaties
CACs	Collective Action Clauses
CRAs	Credit Rating Agencies
CS-DRMS	Commonwealth Secretariat — Debt Recording and Management System
DeMPA	Debt Management Performance Assessment
DMFAS	Debt Management and Financial Analysis System
DSAs	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
ECA	Export Credit Agencies
ECGD	Export Credits Guarantee Department
ECOWAS	Economic Community of West African States
EMEA	Europe Middle East and Africa
EoI	Expression of Interest
EURIBOR	European Interbank Offered Rate

GDA	Government Debt Data
GDP	Gross Domestic Product
GFS	Government Finance Statistics
GRA	General Resources Account
HIPC	Highly Indebted Poor Country
IBRD	International Bank of Reconstruction and Development
ICMA	International Capital Markets Association
IDA	International Development Association
IFI	International Finance Institution
IMF	International Monetary Fund
LIBOR	London Interbank Offered Rate
LIC	Low-Income Countries
LMA	Loan Market Association
MAC	Market Access Countries
MDBs	Multilateral Development Banks
MDRI	Multilateral Debt Relief Initiative
MTDS	Medium Term Debt Management Strategy
MTNs	Medium Term Notes
NSGLs	Non-State Government Loans
NTF	National Transformation Fund
PCGs	Partial Credit Guarantees
PRGs	Partial Risk Guarantees
PRGT	Poverty Reduction and Growth Trust
RfP	Request for Proposal
RMCs	Regional Member Countries
SALM	Sovereign Asset Liability Management
SGLs	State Government Loans
SLCLs	Synthetic Local Currency Loans
SOEs	State Owned Enterprises
SSA	Sovereign Supranational and Agency

UNCTAD  
US-EXIM

United Nations Trade and Development  
US Export Import Bank

# Glossary

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## Acceleration

a clause in a contract, typically a loan or a bond, allowing a creditor to request earlier repayment of the debt if a stated event occurs. For example, if a borrower defaults two or more payments, an acceleration clause may allow a lender to force the borrower to immediately repay the entire loan or bond amount.

## Agent

the financial institution acting as representative of the lenders under a syndicated loan. The role of the agent is to administrate the loan, to take specified decisions on behalf of the lenders, to provide the lenders with the information necessary for their decisions and to enforce the contract in the event of default.

## Arranger

the financial institution engaged by a borrower to facilitate the issuance of a debt in the capital market.

## Balance of payments

a statement of all transactions made between entities in one country and the rest of the world over a defined period of time, such as a quarter or a year.



## Bilateral Investment Treaties (BITs)

an agreement establishing the terms and conditions for private investments by nationals and companies of one State in another State.

## Blue bond

debt instrument issued by a borrower to finance marine and ocean-based projects that have positive environmental, economic, and climate benefits. The blue bond is inspired by the green bond concept.

## Bridge financing

an interim financing option (often in the form of a bridge loan) used by companies and other entities to solve short-term liquidity issues until a long-term financing option can be arranged.

## Callable bond

a bond that can be redeemed by the issuer earlier than its maturity date.

## Collateral

an asset that a borrower offers as a way for a lender to secure the loan.

## Commodity-backed bond

a bond for which the price is linked to the price of a commodity.

## Coupon

the periodic payment paid to the holder of a bond.

## Credit Risk

the risk that the borrower defaults under its financial obligations.

## Cross-currency swap

over-the-counter derivatives in the form of an agreement between two parties to exchange interest payments and principal denominated in two different currencies.

## Debt sustainability

the ability of a government to meet its debt obligations without requiring debt relief or accumulating arrears.

## Debt Sustainability Framework (DSF)

a framework for a country's borrowing decisions to meet their financing needs while maintaining debt sustainability. The DSF provides a framework in Excel format for the analysis of the debt and debt service dynamics under a baseline scenario and a set of standardised economic shocks.

## EURIBOR

daily referenced interest rate used for lending between banks on the European interbank market. It is also used as a reference for setting interest rates on loans.

## Eurobond

an international bond issue denominated in a currency not native to the country where it is issued. It can be categorised according to the currency in which it is issued. Eurobonds are named after the currency in which they are denominated. For example Euroyen and Eurodollar bonds are denominated in Japanese yen and US dollars respectively.

## Export Credit Agency (ECA)

known in trade finance as an “ECA” or investment insurance agency is a private or quasi-government institution that acts as intermediary between national governments and exporters to issue export financing. The financing can take the form of credit or credit insurance and guarantees or both, depending on the mandate the ECA has been given. ECA can also offer credit or cover of their own account. Some agencies are government sponsors, some are private and others are a combination of the two.

## Export credits

loan facility extended to an exporter by a bank in the exporter country. i.e. under a “buy now, pay later” arrangement.

## Green bond

a bond that is specifically earmarked to be used for climate and environmental projects. A green bond, also sometimes called a climate bond, is typically linked to an asset and backed by the issuer's balance sheet.

## Gross Domestic Product (GDP)

the estimated total value of all the finished goods and services produced within a country's borders in a specific time period.

## International/Development Finance Institutions (IFI/DFI)

specialised development banks/ institutions with the ability to raise large amounts of money to provide financing for development projects, program or initiatives for developing countries.

## Issuer

a legal entity such as a corporation, investment trust, government or government agency that develops, registers and sells securities to finance its own operations.

## Judgment creditor

creditor who has proved its debt in a legal proceeding and who is entitled to use judicial process to collect it.

## LIBOR (London Interbank Offered Rate)

benchmark rate that represents the interest rate at which banks offer to lend funds to one another in the international interbank market for short term loans. LIBOR is an average value of the interest rate which is calculated from estimates submitted by the leading global banks on a daily basis. LIBOR serves as a first step to calculate interest rates on various loans throughout the world.

## Limited recourse financing

financing for which the creditor has limited claims on the loan in the event of default.

## Liquidity Risk

financial risk that for a certain period of time a given financial asset, security, or commodity cannot be traded quickly enough in the market without impacting the market price.

## Market Access Countries (MACs)

Countries that typically have significant access to international capital markets as opposed to countries which meet their external financing needs mostly through concessional financing.

## Market Risk

risk associated with the possibility that adverse changes in interest rates, foreign currency exchange rates or commodity prices.

## Mortgage

a debt instrument, secured by the collateral of specified real estate property, that the borrower is obliged to pay back with a predetermined set of payments.

## Multilateral Loan

loan funded by a IFI/DFI.

## Par value

the face value of a bond, i.e. the value of the principal repayable at maturity.

## Premium

the excess value added to the price or cost of a financial asset

## Primary market

market, also known as the 'New Issue Market', is where new securities are initially issued and sold by the borrower.

## Private sector

part of the economy that is run by individuals and companies for profit and is not state-controlled and therefore comprises of businesses that are not owned or operated by the government.

## Private sector loans

loans that are granted by commercial banks (and sometimes funds) on specific terms.

## Project bond

type of bond that ensures that the proceeds of a bond will be used for a specific project.

## Public and Publicly Guaranteed Debt (PPG)

category of debt is used by the IMF in its DSA analysis. It includes the general government debt as well as the debt of SOEs that do not have financial or administrative autonomy.

## Public sector

the general government sector plus government-controlled entities, known as public corporations, whose primary activity is to engage in commercial activities.

## Public sector debt

the aggregate of central government debt and SOE debt.

## Refinancing Risk

risk associated with the maturity of an obligation that may not be refinanced or only be refinanced at a higher cost.

## Request for Expression of Interest (RfEoI)

a solicited invitation from the procuring entity to potential bidders to express interest for a project, mandate or the delivery of services.

## Request for Proposal (RfP)

a solicited invitation from the procuring entity to potential bidders to submit a proposal for a project, mandate or the delivery of services.

## Roadshow

a series of presentations made to potential investors in various locations leading up to a debt offering.

## Secondary market

a market of the resale of already issued and outstanding debt securities.

## Secured debt

a form of debt that allows the holder of the debt (e.g. lender or bondholder) to seize one or more assets in the event of a default by the borrower.

## Security (interest)

Legal right that is granted by a debtor's collateral that allows the lender to have recourse in the eventuality of default.

## Sinking fund

money set aside in fund held by a third party to pay off bonds at maturity.

### Sovereign Asset and Liability Management (SALM) Framework

a framework that allows governments to examine all of the accumulated assets and liabilities that the government controls.

### Sovereign/direct guarantee

a type of guarantee provided by the government to discharge the liability of a third party in case they default from their obligations.

### Special Purpose Vehicle (SPV)

a legal entity created for a limited and specific purpose, typically to hold assets related to a financing.

### State owned enterprise (SOE)

a legal entity wholly or partially owned by a government to participate in specific commercial activities on behalf of the government.

### Syndicated loan

loan issued by a syndicate of lenders acting as a group with common terms and represented by an agent.

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