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AGENCY FOR INTERNATIONAL DEVELOPMENT

Santo Domingo, Dominican Republic

UNITED STATES GOVERNMENT
MEMORANDUM

Date: April 29, 1993

From: Larry K. Laird, Chief, Trade and Investment Office

To: Project Committee and The Files

Subject: Project Assistance Completion Report - Debt Conversion Project (517-0237)

I. SUMMARY PROJECT HISTORY

A. Introduction

This project was authorized on August 24, 1988, as a Grant in the amount of $3,500,000 to the Central Bank, an autonomous GODR agency. The purpose of the project was to establish a well functioning debt conversion mechanism in the Central Bank that could function as a vehicle for increasing foreign and domestic investment. The project was intended as a fifty-three month set of activities to provide technical assistance, equipment and training in order to establish a Debt Conversion Unit (DCU) within the Central Bank. The Central Bank was chosen as direct grantee and recipient of project assistance inasmuch as it was and is the external debt obligor or guarantor and financial agent on all of the Dominican Republic's external debt obligations and, viewed from design and implementation aspects, considered to be the best managed GODR entity. The GODR and USAID obligated the project on August 26, 1988, in the amount of $2,900,000; additional USG obligations did not occur.

The GODR provided counterpart funding mainly by means of committing to supply sovereign debt instruments, for an aggregate face value amount of $100,000,000 for debt conversion, of which approximately $70,000,000 was provided for conversions. Further, counterpart contributions in the form of project-dedicated human resources, physical space and program monitoring tasks were provided on a continual basis.

A contracted technical assistance (TA) team provided all functional project components, program design, computer hardware and software installation, forms design, auction system mechanisms, industry priorities, management information systems, training, organizational structure, and projected macroeconomic effects. In effect,

projected resources created a turn-key debt conversion capability for the Central Bank.

As of the date of the project termination, A.I.D. expenditures totalled $1,371,670, and counterpart cash contributions totalled $69,945,000, in addition to in-kind contributions.

Source	Planned	Actual
USAID	$ 3,500,000	$ 1,371,670
Counterpart (Debt issues offered)	100,000,000	69,945,000
Totals	$103,500,000	$71,316,670

B. Rationale and Project Design

External debt conversion mechanisms were introduced during the mid-1980's, primarily in Latin America, as a way for foreign commercial banks holding non-performing sovereign debt obligations to exchange these debts for equity positions in debtor country public and private corporations. The effect on debtor countries is to receive and cancel the debt obligations, thereby reducing debt and the burden of debt service, which is fixed by contract. The advantage for commercial banks is to transform non-performing debt into shares in an enterprise that will eventually pay dividends in local currency that could be remitted in foreign exchange at some future date, thereby recovering some value for heretofore non-performing loans. The first Latin American to use debt conversion was Chile, which reduced its commercial bank debt by four billion dollars over a five year period. Debt conversions were also executed in Mexico, Venezuela, Honduras, Argentina, Brazil and Jamaica.

For a variety of reasons, commercial banks did not take full advantage of these operations; however, a secondary market for these debt instruments developed and private investors began to purchase this kind of debt for speculative reasons and to participate in investment projects using the purchased debt to convert at a preferable exchange rate to enhance an investment project. Because only financial institutions can legitimately trade debt, investors could fund a bank to purchase the debt on their behalf. This formed a market for the debt, caused the price to rise, and continues to play a role as an incentive for investment promotion. Debt conversion transactions are beneficial to the commercial bank, the investor and to the debtor country. It was a very reasonable assumption that the GODR could design and implement a debt conversion project of this nature to attract foreign and domestic investment and also to reduce its heavy debt.

The true value added of a debt conversion program for the investor is the

additional local currency that the investor receives from a Central Bank; in effect a subsidy for the investment. A carefully designed process is required so that the subsidy is minimized, and that local currency proceeds are disbursed on a programmed and deferred basis so as not to contribute to a rapid increase in money supply. Moreover, the debt conversion process should have internal and external credibility so as not to appear to favor any particular investor. Therefore, a mechanism, such as an auction, is utilized to allow market forces to determine how the investment is discounted. Investment analysis capability is also required to evaluate the viability of projects, their incremental employment potential and foreign exchange earning potential. Forms design and internal management information tools are necessary to monitor these investments and their resulting financial effects.

The debt conversion process is a sophisticated financial market mechanism and requires enhancing existing human and analytical resources available in most Central Banks. The Dominican Republic was considered an excellent candidate for this type of program. From a timing viewpoint, debt conversion is usually best introduced as a country approaches its external creditors to restructure its debt in an integrated fashion since commercial banks, rarely restructure in isolation. Debt agreements need to specify debt reduction devices, making a program viable when banks have restructured their debt. In this matter as well, the Dominican Republic was deemed ready for a debt conversion project when design of this project took place.

C. Implementation

1. Start-Up Phase

Although the Project was authorized on August 24, 1988, implementation was not initiated until July, 1990, when a technical assistance (TA) team was selected and arrived on site. This lengthy delay was a result of a lack of a firm commitment to the project by the Central Bank at that time, and a lack of progress in obtaining an amendment to the Credit Agreements with the commercial banks to permit initiation of debt reduction programs including debt conversions using commercial bank debt. In early 1989, a new Governor of the Central Bank was appointed. He recognized the benefits of the project and initiated a number of debt conversions. The framework of the existing process was very general and the resulting conversions were approved quickly by the Monetary Board, in its role overseeing Central Bank operations. Local investors, sensing a windfall, attempted to obtain pre-project "places in line" at the Central Bank, to the extent that at one point the value of the investment projects in the pipeline was approximately one billion dollars.

In any event, while the Central Bank did "break the ice" with debt conversions, the process was whimsical; conveyed the impression of favoritism; inordinately increased the market price of the debt; and caused negative monetary effects. There was not yet

any TA available to the Central Bank at this stage of the project.

During 1989 and 1990, an overall deterioration of the economy continued. Monetary emission lacked controls with a resulting increase in price levels and budget deficits; the Dominican peso continued to decline in value, the frequency of electrical power outages grew, and little attention was paid to external creditors holding approximately four billion dollars in Dominican debt. Interest payments to the commercial banks ceased and creditor relations were strained. Foreign exchange reserves declined to the extent that imports of petroleum were deferred and fuel oil and gasoline supplies were seriously influenced. The Dominican Republic was in dire need of economic redressment that could only be enhanced by an International Monetary Fund (IMF) sponsored economic program.

In July 1990, a new Central Bank governor was appointed. This coincided with the fielding of a TA team to project implementation support for the project. In spite of no experience in international financial matters, the new governor brought himself up to speed in understanding the objectives of the project. He was, however, initially skeptical about the project. He felt that the prior approach of the Central Bank to debt conversion had been impulsive, that investors had received unwarranted windfalls, that investment projects were receiving subsidies when they would have been undertaken anyway, and that the Central Bank DCU management team was not fully competent to process transactions. Concerned mainly with the process, monetary effects, increased price of the debt, the lack of an arrangement with the banks, the governor suspended all debt conversion activities through December 1990, pending a thorough review of all transactions with the assistance of the newly arrived TA team. Moreover, aware of the legal impediments with bank credit agreements in place, the governor wanted input from project management on all of these issues.

The TA team's initial emphasis, therefore, involved three tasks:

1. Review and advance efforts to select and install an operating and management information system designed to monitor project information, disbursements, project analysis and training;

2. Participate in the review of the then approved project pipeline, redesign new policies, procedures, forms design; and

3. Provide an initial framework to an entire external debt policy and approach.

It was the latter task that the TA team focused on, given the governor's requirements, coupled with the overriding issue that a total debt restructure was necessary to accomplish a debt conversion program.

2. Framework Development Phase

Project priorities through the end of 1990 and the initial months of 1991 were heavily concentrated on orienting the Central Bank on a strategy of total debt normalization, as precursor to debt conversion, particularly assisting the Central Bank in reviewing the IMF Standby Agreement, which was signed in July 1991, and that represented the centerpiece from which all other debt restructurings would flow. The non-commercial bank segment of the Dominican Republic's external debt amounted to 78% of the total, and there was little doubt at the time that the commercial bank portion would fall into place after the restructuring of the more difficult portions - the IMF program, Paris Club debt, the IFI's - were restructured, since the politico-social effects of the IMF-sponsored debt were more far reaching and required developing a basic national consensus.

During this period, project implementation efforts were dedicated primarily to meetings with the Governor and his senior advisors reviewing debt negotiation strategies, options, and recommendations on the Central Bank's internal organization for debt negotiations. From August 1990 through mid-1991, the Central Bank's strategic objective was to reduce the external debt by approximately one billion dollars, or 25% of the total outstanding at the end of 1990. This figure was not unreasonable, given the Costa Rican restructuring that was then recently completed, coupled with President Bush's Enterprise for the Americas Initiative (EAI), which announced debt reduction possibilities with certain of the U.S. entity credits or conversion to local currency obligations, the possibilities of partial condoning of the San Jose Accord debt, a reasonable buy-back with the commercial banks, and debt conversions, less the small increase in debt acquired for the necessary enhancement funds. With a buy-back price of "25 cents on the dollar," a target of 50% of the one billion dollar commercial bank outstandings, the reduction in this category alone would have amounted to 375 million dollars (75% of 50% of the one billion dollars in debt).

Economic conditions dramatically improved during this period: foreign exchange reserves reached record levels; a new agreement with the IMF was concluded; a single, market-driven exchange rate came into play; almost "zero" inflation occurred; real interest rates went down dramatically; improved energy supplies were to be had; a perceived restructuring with the banks was discussed; the underpinnings of a debt conversion program were set in place. All of these factors caused the market price of Dominican debt to increase - from 22 cents to 33 cents on the dollar - and the debt reduction element became more elusive since the higher the price of the debt, the less the debt will be reduced through a conversion mechanism; in other words, the banks would not agree to a fixed buy-back price much lower than the market price. This increase in market price of the debt frustrated the Central Bank in its belief and plans that debt could have been retired for as little as 16 cents on the dollar. Nonetheless, the Central Bank decided in 1991 to buy-back approximately $500 Million in Mexican and

Venezuelan debt at 32.5 cents on the dollar. The issue of real or perceived market price represents one of the two main reasons for the ongoing deferral of the debt conversion process.

3. Conversion Process Phase

Concurrent with reviewing the overall external debt issues, during 1990 and 1991, the Central Bank received project support to advance the mechanics of the debt conversion process. Computer hardware and software for the information systems was installed, the operations staff trained, and the DCU is presently fully staffed and functioning. Technical training of analytical staff, including corporate finance analysis, financial market activities, review of peer country debt conversion programs was completed. The necessary format of the debt conversion project application was designed and represents a compilation of the Chilean, Mexican and Venezuelan programs, selecting the best of each experience. The Central Bank staff is in place to process debt conversions considerably beyond those required to meet project goals. Procedures were elaborated for the entire process, to include preparation of the internal approval mechanisms, encompassing a draft resolution for approval by the Monetary Board, the governing body of the Central Bank. The basic distinction in the project endorsed process for debt conversion is promoting transparency as compared with the "ad hoc-ism" that occurred in previous debt conversions. This is manifested by the determination of the discount rate that the Central Bank applies to the face value of debt delivered for conversion. For example, if the face value is assigned a conversion factor of 50%, then the subsidy is greater and the investment project is greatly enhanced, if compared to a conversion factor of 40% of the face value. This determination of a conversion factor should be market-oriented to ensure transparency, credibility and proper financial benefit for the Dominican Republic. The TA team recommended an auction mechanism wherein the discount is determined by public bid on a periodic and systematic basis. The lowest discount, i.e., the one most favorable to the Central Bank, which results in the lowest local currency "subsidy," would win the bid; losing bids would be eligible for subsequent, but programmed, new auctions. This system has been successfully utilized in other countries. Unfortunately, the Central Bank has felt that this process entails "losing control" of the process to the market, and they prefer controlling the process from start to finish.

By mid-1991, the Mission became very concerned with the continued failure of the Central Bank to obtain approval by the Monetary Board of the regulations establishing new, transparent, debt conversion procedures, which had been developed with project-funded TA assistance. Further, the GODR was making very little progress in reaching agreement with its commercial creditors, thus adding another key, missing element in a successful debt conversion process. This all came to a head in October 1991, at which time, the Governor of the Central Bank asked A.I.D. if it would agree to suspend the TA under the project until the Central Bank could complete its negotiations with the country's commercial creditors. The Governor was very pleased with the assistance he

had received under the project to date. He felt, however, that he had learned all that he could from project advisors. It was now up to him to finish the negotiations. The Mission accepted the request made by Governor of the Central Bank. On November 19, 1991, the Mission issued PIL No. 16 which curtailed the activities and expenditures under the Debt Conversion Project until such a time as the Central Bank and A.I.D. jointly agreed to resume such activities. Because the Central Bank did not complete an agreement with the country's commercial creditors before the PACD, project-funded activities never resumed.

II. DELIVERY OF PROJECT INPUTS

A. Institutional Strengthening

Budgeted	Actual
$2,400,000	$1,029,091

This accounting line item - often listed as Technical Assistance only in other projects - was established to permit allocation and disbursement of funds ($2,400,000) for work carried out by the institutional contractor (Ernst & Young and their sub-contractors, L.A. Debt and Socimer, Inc.), computer hardware, software and other furnishings required by the project. Of the total amount budgeted for the project, the major portion was dedicated to institutional strengthening, process design, electronic systems installation, internal presentations, all of which were accomplished during regular visitations by the TA team.

B. Project Advisor

Budgeted	Actual
$500,000	$342,579

A resident project advisor (Personal Services Contractor, PSC) was contracted to liaise with the Central Bank and the TA team, and $500,000 were set aside for this purpose. However, because the Central Bank considerably reduced the project's scope by not coming to closure with the commercial banks, the PSC's contract was cancelled in December 1991.

C. Evaluation and Audits

Budgeted	Actual
$ -0-	$ -0-

A mid-term evaluation was performed by Louis Berger International, Inc., in August 1991. Because the project was experiencing little formal progress and the USAID and the Central Bank were not in agreement on a course to follow, rather than seeking joint funding approval for this evaluation, the Mission used PD&S funding of $28,000 to carry out the evaluation. Over the course of the project, no funds were ever obligated for this line item and additional external evaluations are not considered necessary.

D. Termination Costs

Nothing has been budgeted nor are any costs envisioned.

III. COUNTERPART CONTRIBUTIONS

Planned	Actual
$100,000,000	$69,945,000

Excluding contributions in-kind, these counterpart contributions represent the GODR's "delivery" of US$100 Million in debt instruments to be converted to investments. The GODR supplied US$69,945,000 in debt instruments prior to suspension of the program.

IV. PROJECT ACCOMPLISHMENTS (OUTPUTS)

	Planned	Actual
1.	A Debt Conversion Unit within the Directorate of Foreign Investment:	
	a. One established	Completed
	b. Staffed (12)	Completed
	c. Equipped (%)	100%
2.	Staff of DCU trained and fully capable of carrying out all their functions (12).	12
3.	Staff of related Central Bank Units trained and fully capable of carrying out all debt conversion-related functions (10).	15

4.	New and more useful regulations governing operation of the Debt Conversion program drawn up, reviewed and formally adopted and put into practice by the Central Bank.	The Central Bank was unwilling to utilize the project's recommended operating procedures.
5.	Specific GODR-owned assets identified as "privatization targets" under the Debt Conversion Program, and plans drawn up for effecting their sale.	No assets were identified.
6.	30 debt conversion projects completed.	18 completed

To date, 18 projects have been approved, resulting in US$69,945,000 in external debt instruments being tendered to the Central Bank. This represents 1.7% of the total average outstanding external debt as of 5/31/90. These "tenderings" generated RD$306,878,000 in local currency disbursed for eighteen investment projects approved and disbursed in the following broad investment categories: tourism (5); environment and social development (3); commercial bank recapitalization (4); commercial and industrial uses (6).

On the broader issue of external debt strategy, the GODR reestablished open communications with the commercial banks, the IMF and other external creditors. The project TA team initially analyzed the GODR economic statistics from the viewpoint of the IMF, reviewed results with Central Bank management, presented a negotiation strategy that culminated in an approved IMF economic program in August 1991. Also, the project management team assisted in approaching the Paris Club group of official creditors to ascertain possible terms and conditions for debt restructuring, which was formally agreed to on November 22, 1991. The project also assisted in compiling and preparing a proposed menu of options using information from recent U.S. Treasury (Brady Plan) debt restructurings completed with other countries in the Latin American region in order to provide a framework for a possible debt renegotiation. This renegotiation, however, has not as yet occurred.

On another note the project analyzed and prepared analyses to present to the San Jose Accord creditors, Venezuela and Mexico, which the GODR utilized to repurchase at a significant discount approximately US$500 Million in past due loans. This transaction opened the way for new petroleum credits from these two main suppliers. All of the foregoing was done to enable the GODR to enter into a new debt agreement with the commercial banks with provisions respective documentation to allow for debt conversion using lender bank debt instruments. The non-commercial bank portion of the GODR's four billion in external debt amounts to 78% of total. This has been

restructured under the auspices of the Paris Club and has been the project's most significant accomplishment. At this juncture, the GODR is technically able to conclude debt restructurings with the commercial banks; however, the GODR negotiators still have not reached a final resolution.

V. PROGRESS TOWARD ACHIEVEMENT OF PROJECT PURPOSE

The project was only partially completed due to the aforementioned factors. Far more was accomplished in the overall debt strategy preparation, education of the GODR representatives, informal contacts with the creditors to determine the realm of negotiation possibilities, sensitivity analysis of options to approach creditors, and an accumulation of information on status of debt restructurings with peer countries. However, sorely missing from the equation is the settlement with the commercial banks.

VI. PROJECT DESIGN ADJUSTMENTS

There were no significant project design adjustments. However, designers of similar projects may find the following guidelines useful before considering this type of project:

- Ensure that debt holder documentation permits debt conversions or any other debt reduction mechanisms. A.I.D. Legal Counsel should review and issue a formal opinion.

- Initial coordination with the U.S. Treasury would be useful insofar that this Department monitors the debt status of each restructuring country on a continual basis.

- Consider funding integrated external debt advisory services. U.S. lender bank members of international loan syndicates will be favored by having experienced TA counsel the borrower country by at least placing the country debt negotiating team "in the ball park". Many countries contract very expensive investment banking firms to fulfill this role, many of which are U.S. based. U.S. banks will benefit from this kind of advice.

- Exercise greater circumspection (a reduced budget) with respect to the electronic systems investment when the number of transactions, even in the most aggressive scenario, may be limited.

VII. REQUIREMENT FOR CONTINUED MONITORING

None.

VIII. REQUIREMENT FOR FURTHER DATA ANALYSIS OR EVALUATION

None.

IX. SUMMARY OF LESSONS LEARNED

1. Three Central Bank governors were appointed during early project discussions, design, approval and implementation. The project had to accommodate the significant variations in approach of all three. Hence, careful judgment is required to determine just how attitudes can be accommodated in light of project objectives.

2. Debt conversion represents only one of the elements of debt reduction and implementation is dependent on the fate of the much larger issue of total debt restructuring. Inasmuch as this latter action is the overarching point and debt conversion a residual one, the original project concept could have been expanded and redesigned to encompass external debt consultation as the central focus of the project's TA support. As matters turned out, project management was in the position of evaluating progress on a much more limited issue while providing assistance to the Central Bank on a much more expanded project, that of overall debt management. This represented the primary effort in order to attain the more limited goal of establishing a debt conversion program.

3. Electronic data processing systems and support were inflated in design. The management information systems (MIS) support was greater than the volume of projected operations warranted. A more basic installation would have sufficed.

ANNEX

WHAT IS A DEBT CONVERSION?

Debt conversions are mechanisms that allow banks, holders of non-performing sovereign debt, to convert dubious assets for shares or another equity position in a public or private company as a minority investor. Debt has a fixed claim with respect to principal and interest payments that are invariable unless renegotiated. Equity investments are subject to profits in local currency; the lack of a definite requirement to convert to dollars, however, represents an alternative to recover bad loans. For the sovereign debtor, a conversion offers a means of attracting new investment and gradually decreasing debt and debt service. Operationally, a holder of sovereign debt, usually a bank, sells that debt at market prices to an investor who has identified an investment project in the debtor country. The investor, who now owns the debt, converts it at the Central Bank of the debtor country at a discount from its face value in exchange for local currency, or parastatal-owned assets in the case of a privatization, for use in an investment project. The Central Bank discount is designed to share some of the profit between the debt purchase at market value and the face value. Transactions usually follow a procedure established and controlled by the Central Bank. The investor, in effect, receives a subsidy, i.e., the difference between the official exchange rate for investments and the actual real rate of exchange received, which is the result of the conversion at the Central Bank.

CONTRACTUAL CONSTRAINTS - COMMERCIAL BANK DEBT CONVERSIONS

There are contractual impediments to the debt reduction operations, including debt conversions, which preclude fluid transactions. Loan agreements between debtor countries and commercial banking syndicates contain two basic impediments:

A. A prepayment clause - a syndicate member lender cannot be prepaid by a borrower to the detriment of other members of the syndicate. This precludes a member bank "getting an advantage" by receiving in payment some form of asset, whether cash, fixed assets, shares, etc. A member bank that converts its credits for local currency or shares - the essence of a debt conversion - receives a payment, which in most cases, is a "prepayment," since the remaining syndicate members who do not choose to convert receive nothing. The converting holder is thereby advantaged, thus violating the stipulation in the loan agreements.

B. A Pro Rata (or sharing) clause - requires that any syndicate member bank who receives in payment cash, shares, land, sugar cane, etc., is required to share these payments pro rata among all of the syndicate member banks proportional to the recipient's share of the total loan amount.

Both of these clauses are eminently reasonable in bank syndicates and were devised many years ago to avoid politization and preferential treatment of favored country banks in case of political difficulties, the most recent example being the syndicated loans to Argentina during the Falklands war when Argentine law prohibited payments to U.K. syndicate members. These clauses protected the British banks since other banks had to share loan payments with them. To permit individual banks to engage in debt reduction transactions therefore, bank lenders and borrowers have either to amend existing loan agreements or prepare new loan agreements to incorporate text to permit debt reduction programs.

As a practical matter, this means that borrowers have to renegotiate external obligations with lender banks to obtain new loan agreements. The mechanics of the amendment process are exceedingly cumbersome even if all of the lender banks are favorably disposed to amend that is rarely the case.

The foregoing contractual limitations apply to most all debtor countries including the Dominican Republic.

Clearances:

TIO:KWiegand (Draft)	Date: 03/12/93 (first version)
TIO:LLaird By phone, per RFR	Date: 09/28/93
CON:WButler	Date: 9/29/93
PDO:DChiriboga	Date: 9/29/93
DD:FJConway (Draft)	Date: 09/23/93
DIR:RFRifenburg	Date: 9/23/93

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