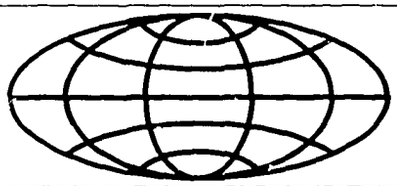
# A GUIDE TO DEBT FOR DEVELOPMENT



## Making the International Debt Crisis Work for Development

# A GUIDE TO DEBT FOR DEVELOPMENT

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# TABLE OF CONTENTS


| | |
|---|---|
| Credits | i |
| Preface | iii |
| The Debt Problem | 1 |
| The Public Policy Response | 3 |
| The Debt-for-Development Initiative | 4 |
| Debt for Development, Not for Everyone | 6 |
| What is Debt Conversion? | 7 |
| Doing a Debt Conversion | 9 |
| Some Issues | 10 |
| Types of Debt Conversions | 13 |
| Debt for Equity | 13 |
| Debt for Donations | 15 |
| Debt for Development | 16 |
| Debt for Debt | 16 |
| Debt for Bonds | 17 |
| Where to Begin | 19 |
| The Initial Step | 20 |
| Getting a Banker's Perspective | 22 |
| Investors and Other Sources of Funds | 24 |
| The Deal | 25 |
| The Conversion Process | 27 |
| Conclusions | 31 |

*Figures*

| | |
|---|---|
| *Table -- Major Bank Third World Debt Exposure* | *2* |
| *Chart -- Comparative Analysis of Debt Conversion* | *12* |
| *1. Debt Conversion* | |
| *2. Straight Currency Exchange* | |
| *3. Comparative Yields* | |

# CREDITS

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Many ideas contained in this guide were generated through the interaction of participants at a workshop held in Washington, D.C., in December 1988 involving central bank officials from developing countries, representatives of indigenous cooperatives and cooperative banks, members of the U.S. banking community, executives of U.S. cooperative development organizations, and other specialists in international development.

The grant also provided for field missions to Costa Rica and Jamaica to design debt-for-development proposals. This document attempts to capture this experience.

The guide relies extensively on information and advice provided by John B. Ross, executive director of The Debt-for-Development Coalition, Washington, who participated in all project activities and reviewed drafts. Overall project guidance and support were given by VOCA's President Don Cohen, assisted by Joan Leavitt and Bill O'Callaghan. Consultants Carol James and Lynn Zempel helped write and produce this guide.

What was learned during this process applies broadly to not-for-profit activity and, thus, this discussion is not restricted to financing cooperatives.

The conversion of LDC debt for not-for-profit development purposes is an emerging discipline. This document is meant to be a

helpful resource to organizations interested in undertaking debt conversions, but it is not intended to supplant retention of qualified technical assistance in executing these transactions. While information contained in this document was drawn from sources considered generally reliable, accuracy cannot be fully assured.

Interpretations in this document do not represent official views of the U.S. Agency for International Development.

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# PREFACE

The international debt crisis is deepening. Private lenders and government policymakers in industrialized countries, which hold about $1.3 trillion in Third World debt, and leaders of debtor countries increasingly recognize that overall debt reduction must be achieved and interest payments reduced.

Debt conversion can be an integral component in addressing the growing worldwide financial problem and can underpin strategies for achieving Third World development. Finding ways to convert debt to development purposes will improve prospects for overall debt repayment in the long-term.

While debt conversion is a normal commercial transaction well understood by sophisticated financiers in the conduct of business enterprise, until recently it seldom had been applied by organizations involved largely in not-for-profit enterprise.

Not-for-profit organizations involved in international development have an opportunity to multiply their existing capital -- to leverage what frequently are scarce resources -- by applying debt conversion techniques to achieve their development goals.

The term *"not for profit,"* used throughout this discussion, is meant to include a broad range of private voluntary organizations, cooperative development organizations, cooperatives, advocacy groups, labor organizations, environmental groups, colleges and universities, research institutions, foundations, and charitable and religious institutions.

This guide is intended to help managers of not-for-profit organizations and development specialists learn about debt conversion in a nontechnical way -- including how to identify opportunities, and some of the issues to consider when assessing debt-for-development transactions.

"*Debt for development*" has become the accepted vernacular to describe not-for-profit organizations' use of debt conversion techniques to achieve people-to-people international development assistance objectives. While businesses and commercial lenders rightly state that they, too, use debt capital or lend for the purposes of development, this discussion adapts the term "debt for development" to describe debt conversions primarily for not-for-profit enterpise.

Debt for development can benefit all participants involved. The bright prospects for use of debt conversion techniques have spurred initiatives by the U.S. government, LDC governments, leading development experts, and bankers to make the concept become a reality.

Important tasks remain; chief among them is informing individuals and organizations so that they can put debt-for-development techniques to use. By involving the not-for-profit community in funding constructive applications, the concept of debt for development can be converted from relatively limited application today into widespread use. This guide is a step toward that goal.

# THE DEBT PROBLEM

The Third World debt crisis exacts a tremendous social and economic toll on the citizens of all nations, creating a vortex of downward-spiraling effects. To repay their debts, poor nations have been transferring resources to rich nations at record levels, further damaging their economies. Developing countries' struggle to repay loans comes at the expense of domestic growth and social programs. As a result, Third World development is getting worse and not better.

Wall Street and U.S. public policymakers have expressed concerns about the implications of heavy LDC debt exposure on the viability of prominent U.S. banks. Some money center banks had Third World loans that exceeded their total capital and reserves at the end of 1988.

While some innovative measures have been taken to deal with the Third World debt crisis, no permanent solution is imminent.

Mexico's 1982 declaration that it could not service its debts was a salvo heard on financial markets throughout the globe, despite the fact that other countries, including Bolivia, Costa Rica, and Peru had been unable to make debt service payments even earlier.

A predictable response has ensued. Commercial banks resist new lending to developing nations. A World Bank affiliate agency estimates direct foreign investments from industrialized to developing countries fell to $13 billion in 1987 from $25 billion in 1982, making it harder for heavily-indebted developing countries to come up with foreign currency to service existing debt, let alone to buy needed imports or even replacement parts.

Austerity programs now in place throughout Africa, Latin America, the Caribbean, Eastern Europe, and in the Philippines adversely affect quality of life, diminish U.S. exports, and ultimately result in lost U.S. employment.

## Major Bank Third World Debt Exposure

*(In millions of dollars; as of end of 1988)*

| Bank | 1988 Losses Taken | Debt Exposure | Third World Debt Reserves | Exposure as % of Capital and Reserves |
|---|---|---|---|---|
| BankAmerica | $ 119 | $ 9,000 | $ 2,500 | 135% |
| Bank of Boston | 59 | 579 | 359 | 24 |
| Bank of New York | 38 | 2,300 | 600 | 68 |
| Bankers Trust | 0 | 4,000 | 1,000 | 89 |
| Chase Manhattan | 362 | 7,900 | 2,000 | 114 |
| Chemical | 94 | 5,909 | 1,309 | 112 |
| Citicorp | 408 | 12,076 | 2,876 | 95 |
| First Interstate | 281 | 841 | 309 | 33 |
| First Chicago | 321 | 2,125 | 925 | 65 |
| Manufacturers Hanover | 255 | 8,357 | 1,707 | 168 |
| J.P. Morgan | 435 | 4,600 | 1,150 | 66 |
| Republic | 68 | 430 | 170 | 27 |
| Security Pacific | 663 | 852 | 302 | 21 |
| Wells Fargo | 714 | 500 | 150 | 18 |
| **Composite** | **$ 3,815** | **$59,469** | **$ 15,357** | **87%** |

*SOURCE: Salomon Brothers*
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# THE PUBLIC POLICY RESPONSE

In March 1989, Treasury Secretary Nicholas F. Brady announced a program to embrace new ideas providing creditor flexibility – including "debt conversions." Debt conversions or "debt swaps" include debt for debt, debt for equity, debt for trade or commodities, debt for nature, and debt for bonds of a lower value but with guaranteed principal. Debt for development has particular appeal because it can provide broader benefits for a number of parties involved, which in turn can address social issues, thus extending the benefits.

The Brady Program envisions overall reductions in interest and/or principal and assumes that new loans will be made available where they are needed. The World Bank and the International Monetary Fund will make money available to guarantee repayment of some remaining debts where banks agree to reduce amounts owed. By including debt-for-development provisions in International Monetary Fund and other international funding agreements, austerity programs can be eased and new investments for development encouraged.

The Brady Program builds on a plan introduced by then-Treasury Secretary James Baker in 1985 to promote economic growth in heavily-indebted developing countries through economic adjustments coupled with new commercial bank loans, and, implicitly, additional multilateral development bank lending.

While new loans were made to a few of the largest and most economically advanced developing nations after Secretary Baker's announcement, commercial banks actually reduced their overall exposure to heavily indebted developing countries. In response, Secretary Baker and private financial innovators refined the program by developing a voluntary, market-oriented, "menu" approach of negotiated options for restructuring debt tailored to the needs of each country and its creditor banks.

The Brady Program broadens Baker's menu concept.

The international debt problem can be alleviated only through a combination of traditional and innovative approaches. While the full potential of major debt conversion initiatives under Secretary Brady are uncertain, most encouragingly for the not-for-profit community, the Brady Program specifically embraces the concept of debt conversion for purposes of not-for-profit, people-to-people, development programs.

The initial success of the Brady Program in Mexico and its prospects in other countries appears hopeful. However, its approach including the limited resources of the multilateral development agencies and the willingness of banks to both reduce their debt and initiate new investments remains cloudy.

## The Debt-for-Development Initiative

Debt for development grew out of an initiative by not-for-profit organizations which recognized that the conversion process presents an opportunity to expand their capabilities to provide technical and other forms of assistance to developing countries. It has particular appeal because it opens up possibilities of relative large amounts of funding in many countries which are not major recipients of U.S. government foreign assistance.

This concept is strongly supported by the Bush Administration and Congress, which have supported debt for development through regulations and legislation.

Under a policy and guidelines issued February 15, 1989, the U.S. Agency for International Development encourages debt-for-development transactions for a wide range of development activities undertaken by U.S. not-for-profit organizations with AID support. Only economic support fund (ESF) and development assistance (DA) funds are eligible for use in debt conversions. AID's initiative creates opportunities for U.S. not-for-profit organizations which are in a position to undertake new programs or to expand activities in countries which encourage debt conversion. AID's program is likely to be especially applicable to organizations working with indigenous groups.

The debt-for-development policy permits eligible not-for-profit organizations to use AID funds to buy debt owed by developing countries to foreign creditors for conversion into local currency to finance AID-approved development projects and programs.

Not-for-profit organizations buy this debt at prevailing discount rates on the secondary market. Local currencies generated

through using AID funds may finance either new or ongoing activities.

Each activity financed through a debt-for-development transaction must be preapproved by AID and comply with standard rules and procedures.

In some cases AID will help not-for-profit organizations prepare debt-for-development proposals; however, AID does not negotiate transactions or enforce agreements among parties involved in a debt conversion.

Before AID will agree to finance a debt-for-development transaction, it requires eligible not-for-profit organizations to meet a series of specific requirements including:

1. Identification of assets to be obtained;

2. Program activity to be financed;

3. Agreement -- at least in principle -- with the debtor country on the terms, mechanism, and schedule for conversion;

4. A budget and plan for the use of host country assets to achieve project purposes;

5. Demonstration that the applicant has analyzed the secondary market to determine a fair market price for the debt exchange.

Under its debt-for-development initiative, AID also will provide for the retirement of foreign debt in exchange for resources the debtor country provides for use in development activities, including AID-financed projects undertaken by not-for-profit organizations.

With AID support, The Debt-for-Development Coalition has been created to help not-for-profits become involved in this process by providing information and education. The coalition includes cooperatives, private voluntary organizations, international agricultural research centers, and colleges and universities. The coalition also seeks to work closely with environmental groups and others interested in debt for development.

The Debt-for-Development Foundation was recently established to assist not-for-profit organizations in debt conversion transactions, particularly in arrangements which involve a number of development organizations.

## Debt for Development, Not for Everyone

To best use debt conversion as a financial tool for funding development activities, a not-for-profit organization structuring these arrangements should have a solid understanding of financing, management time and organizational staying power to work out complex and often prolonged negotiations, and a willingness to accept some risk. Debt conversion is not a funding option for every organization, every type of project, or every LDC country.

Several larger not-for-profit organizations are investing in building expertise within their own organizations to undertake these transactions, creating separate departments or even new subsidiaries. Smaller organizations will require outside technical assistance. Some organizations may want to participate through pooling with a larger organization or group.

Some not-for-profit organizations oppose the concept of debt for development, espousing forgiveness of loans to poor countries or outright donations of loans for development.

Much initial interest by not-for-profit organizations in debt for development concerned prospects for donations. However, near-term prospects are limited and the potential remains promising but distant. Bankers and other investors are reluctant to pursue this alternative in part because it sets an unwelcome precedent for loans they still expect to collect and also because they face technical hurdles, including treatment of donations by financial regulators, accounting for debt donations for securities registration and tax purposes, determining debt values for monetary conversion, and compliance with U.S. and host country laws.

To succeed, debt-for-development concepts must yield measurable benefits to all participants involved in these transactions. As a result, not-for-profit organizations seeking to undertake debt-for-development projects will need to assess projects from a variety of vantage points and describe their objectives in terms which will satisfy the interests of various groups -- bankers, policymakers, other not-for-profit groups, and ultimate beneficiaries in local communities where projects will be undertaken.

Seldom do most not-for-profit organizations view their work as a "business deal," but this will be a banker's perspective in assessing whether or not it will participate in undertaking a debt conversion. The often complex tasks involved can be daunting, but rewards are achievable. In many nations of the world, not-for-profit organizations are beginning to build a track record of converting debt into development projects.

# WHAT IS DEBT CONVERSION?

**Debt conversion** probably has existed from the dawn of lending and borrowing. It takes many forms.

- Lenders frequently take an equity or ownership stake in a borrower's enterprise in exchange for a debt owed.

- Another common form of debt conversion is to swap one debt or debt instrument, such as a bond, for another debt.

- A lender can make an outright gift of a loan, whether forgiving debt outright or donating the loan to another institution or individual.

Lenders routinely buy, sell, and swap loans with other investors on a **"secondary market"** or resale market – sometimes to invest surplus cash, sometimes to raise cash, and often to achieve balance, or to minimize risk of overexposure to loss, in their loan portfolios. Most Americans are familiar with Fannie Mae, Freddie Mac, and Sallie Mae – all domestic secondary markets where securities backed by packages of billions of dollars worth of U.S. home loans or student loans routinely are bought and sold, mostly by major U.S. and foreign institutional investors. The price of these loan-backed securities on the secondary market varies day to day, depending on how buyers and sellers trading them rate a given security's yield and take into account other marketplace factors.

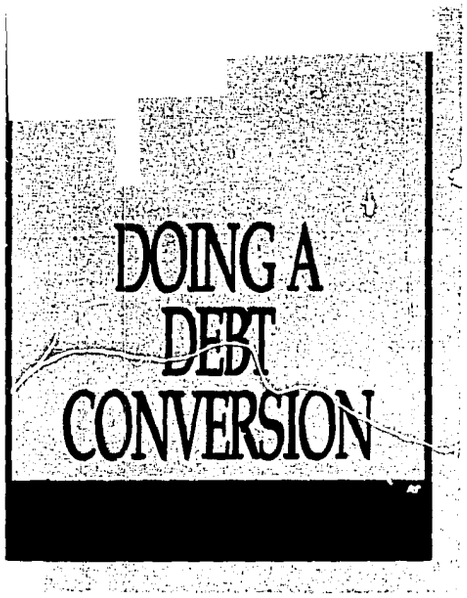
So too are loans held by private creditors to many Third World governments bought, sold, and swapped on an international secondary market by major U.S. and foreign financial institutions and other investors. This market emerged largely among financial traders and regional and smaller banks anxious to reduce their debt portfolios, but now many large money center banks (banks in "money centers" – New York, Los Angeles, London, and Tokyo)

actively participate in this secondary market as well.

The price of LDC debt on the secondary market varies greatly; a number of countries' loans sell at full face value, while others' loans may be severely discounted and sold on a very limited basis. A small but growing portion of total Third World debt actually is traded. Some large, money center banks are reluctant to sell loans from their own portfolios, but will broker transactions for others.

The value or price of loans on the secondary market varies depending on such factors as repayment history or likelihood of repayment, investor confidence in a country's economic situation, and many other factors -- including how badly the seller of the loan needs the liquidity of having cash rather than holding onto a comparatively illiquid investment. In heavily-indebted countries, where the prospects for repayment are dim, the secondary market has established values for these loans at only a fraction of their original face value.

The debt conversion process involves a marriage of interests among a number of parties, for example: (1) A not-for-profit organization which seeks capital to finance a development activity it has identified; (2) a bank or organization holding an LDC debt (usually owed by an LDC government, but sometimes owed by private-sector LDC borrowers), and (3) the LDC central bank.




First, the not-for-profit organization identifies a development project it seeks to undertake with a local counterpart organization and determines a budget. It is an instructive exercise for a not-for-profit organization to prepare a comparative analysis of the benefits and costs of funding a project directly or funding it through the use of debt conversion.

To figure the latter, the not-for-profit organization determines how much it would cost on the secondary market to buy a debt obligation of the LDC country in which it seeks to undertake the project. The value of the debt or its price on the secondary market is usually far less than the face value of the debt. Therefore, for example, a not-for-profit organization conceivably could buy from a lender for $500,000 an LDC debt with an original face value of $1,000,000.

Without a debt conversion, the LDC government, through its central bank, is liable for the full face value of this debt plus interest in the denomination in which the money originally was borrowed, most likely U.S. dollars. However, using the debt conversion mechanism, the LDC government can pay the debt in its own local currency, thus saving precious foreign exchange.

To fund a project through the debt conversion mechanism, the not-for-profit organization and its local partner must convince the central bank and other LDC government policymakers that the purpose of the project it seeks to finance through use of the debt conversion meets the social, economic, and political priorities of the country.

Negotiations are undertaken among the not-for-profit organization, the lender, and the LDC central bank. Central banks are responsible for managing a country's internal and foreign debt obligations and its internal money supply. They generally exert tremendous influence over domestic policy. The not-for-profit or-

ganization must offer a compelling argument that the project it proposes merits use of the LDC's resources – local currency (which the central bank either must raise from the country's domestic budget revenues or issue currency or internal debt obligations to support), land, or equity in an asset it owns such as a parastatal company.

If approval is given, the central bank will agree to convert the face value of the debt of $1,000,000 into local currency or another type of resource worth $1,000,000 to finance the development project. Depending partly upon how worthy the central bank deems the project to be, it will issue payment in local currency or other assets for the full value of the loan or it may discount the value somewhat. The central bank may also charge a fee.

In return, the not-for-profit organization will make available sufficient dollars to retire the outstanding debt obligation by purchasing it at the secondary market price.

Through use of the debt conversion process as outlined, a Third World country no longer owes a debt to an external investor – whether a private bank or a foreign government. The debt conversion process has taken an "external debt" or "dollar-denominated debt" payable in dollars and converted it into an obligation denominated in the country's own currency and held internally to be used for local investment.

## Some Issues

Conversion of Third World debt involves many tangible and intangible variables, including:

- the value or price of the debt on the secondary market,
- LDC economic, social, and monetary priorities, and
- the percentage of face value the LDC government pays.

These transactions involve layers of negotiations and approvals. Because legal and financial arrangements involved in Third World debt conversions are complex and must occur simultaneously, often negotiated in several languages, an experienced broker usually is required to handle them.

Where dollars must be converted into local currencies for investment or development purposes, this process provides a multiplier effect for expanding foreign investment in development projects while enabling the host government's central bank to set policies and determine ground rules for such investments. The central bank can use debt conversion to favor high priority investments,

for example to attract foreign capital for export activities. Debt conversion also can provide a significant resource for supporting socially worthwhile developmental activities.

The chart on the next page shows a comparative analysis of debt conversion and a straight currency exchange. In this example, the not-for-profit organization has $600,000 for local currency costs for a development project. The not-for-profit already has determined that the central bank will approve its project for a debt conversion. The exchange rate is 20 pesos to one dollar. The not-for-profit has secured a broker to negotiate and facilitate the transaction. While an oversimplification, the chart illustrates basic concepts.

A number of countries promote debt-for-development programs and are developing incentives for debt-for-development transactions. One incentive is to vary the currency conversion rate depending on the country's development priorities. One Caribbean country plans to implement a variable discount rate ranging from 2% to 35%, the lower rate applying to labor-intensive, manufacturing projects to produce export products from local raw materials.

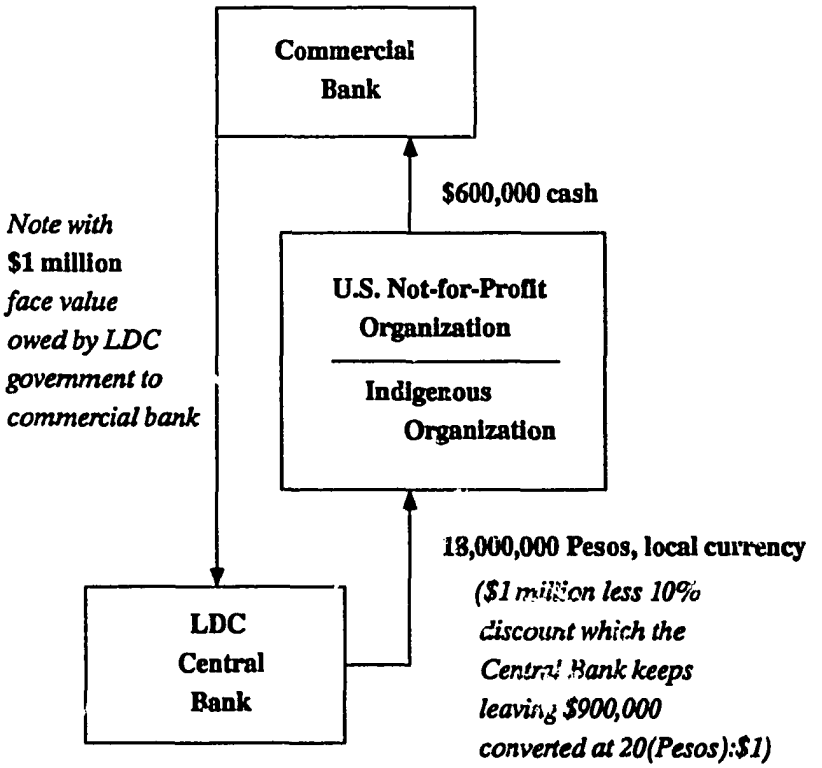
The central bank is usually the most important decision maker in debt conversions, issuing regulations for conversions and approving each transaction. Central banks and governments are concerned about how debt conversion will affect domestic inflation as new local currencies are released into the money supply. Debt conversion programs can be on-and-off again affairs depending on national politics and changes in laws and regulations. Countries usually limit local currency available annually for debt conversions. For example, Costa Rica has limited its initial debt-for-development program to $15 million a year for three years for education, environment, and micro-enterprise development. Applicants compete within this pool.

Debt conversion programs vary widely by country. They may be formal, or covered by existing regulations. Formal programs often are geared to equity investments which promote export activities. Or debt conversion programs may be informal, allowed to occur in the marketplace or through special agreements with the central bank -- frequently a more successful circumstance when proposed developmental activities enjoy strong host government or political support.

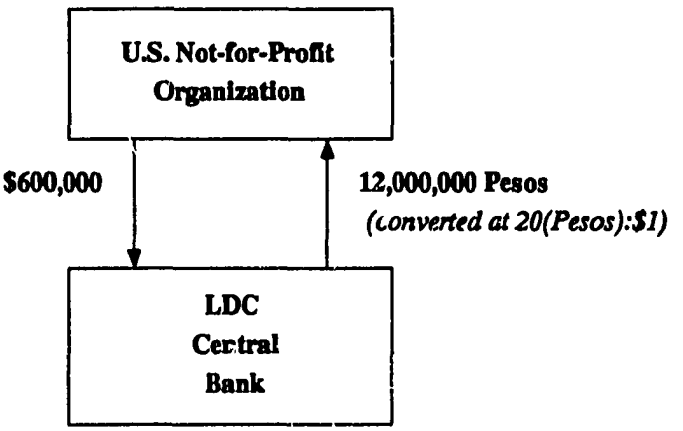
Some countries have both formal and informal debt conversion programs. For example, Brazil has reduced its debt by about $2.5 billion through its formal program, and $6-to-$8 billion through informal conversions.

# Comparative Analysis of Debt Conversion

## 1. Debt Conversion




## 2. Straight Currency Exchange




## 3. Comparative Yields

| | |
|---|---|
| **Debt Conversion** | **18,000,000 Pesos** |
| **Straight Currency Exchange** | **12,000,000 Pesos** |
| **Net Gain Using Debt Conversion** | **6,000,000 Pesos** |
| | **$300,000 equivalent at 20(Pesos):$1** |

# TYPES OF DEBT CONVERSIONS

There are many uses for the proceeds of debt conversions: debt for equity, debt for development, debt for trade, debt for nature, debt for education, etc. For each new application, debt conversion can take on a new name.

As described earlier, there are numerous variations of the debt conversion concept, but the basic transaction is the exchange of outstanding external debt, owed to a bank, government, or other entity, for some form of internal debt or equity instrument. The ultimate result may be an outright donation, a creditor equity position in a business enterprise, a set-aside of land or other natural resources for conservation, or a new debt denominated in local currency to be used for a development purpose.

A significant number of manufacturers are using the conversion process to leverage dollar resources for local currency activities. A growing number of not-for-profit organizations are using debt swaps to purchase commercial bank loans for debt-for-development conversions.

Major types of debt conversions need to be differentiated.

## Debt for Equity

The most widely used debt conversion application is debt for equity, which is a way to reduce outstanding debt, encourage local investment, and boost economic growth. Many developing country governments give priority to equity investments that promote exports. Some of these programs also are designed to help debtor nations recover "flight capital" or capital which has been invested by its citizens outside of the country. External debt (denominated in U.S. dollars or other hard currencies) is repaid in the debtor's local currency, which is then used to purchase an equity or ownership position in a business in the debtor country.

Few banks have converted loans into local currency investments. Rather than convert their debt into investments for their own portfolios, commercial banks usually sell their LDC debt at a substantial discount to nonbank investors. However, recent changes in Federal Reserve regulations have increased the attractiveness of equity participation for some U.S. banks. Regulations now permit them to hold up to 40% of the equity in a private-sector, nonfinancial company, and up to 100% of the equity in a firm being "privatized" through a debt-for-equity conversion.

Debt for equity is a technique which not-for-profit organizations can use for development purposes. For example, a major U.S. not-for-profit group has established a for-profit subsidiary to create local investment companies in developing countries. These investment companies, in turn, will identify and negotiate investment packages for debt-for-equity conversions for small businesses. The investment company also will provide technical assistance. Potential profits will be invested in other development projects. Another major U.S. not-for-profit organization seeks to use debt-for-equity conversions to help cooperatives in Central America diversify their exports.

Among all types of debt conversions, debt-for-equity holds the greatest immediate prospects for success. Not-for-profit organizations may have to rethink or redesign their development projects with debt-for-equity conversions in mind in order to attract investors.

As a means of conserving their foreign exchange, central banks usually require a three-to-five year waiting period between the date local currency is issued and the date an investor may purchase dollars from the central bank for "repatriation" of dividends abroad. An even longer period usually is required before capital may be repatriated. Attempts to convert local currency received through debt conversion back into dollars before this waiting period is over is known as "round tripping."

Round tripping occurs when the investor takes local currency and converts it back into dollars or other foreign currencies. It is possible for investors to reconvert currencies at rates that yield more hard currency than was originally used in the transaction. Substantial financial gains are possible using these techniques. In effect the investor moves quickly from hard currency to local currency and back to hard currency, thus the term "round tripping." (In Europe the term "the bicycle" is used rather than "round tripping.") This type of transaction is prohibited in any type of debt conversion.

## Debt for Donations

Many not-for-profit organizations have envisioned great promise in debt for donations. This conversion approach allows a bank or another creditor to donate debt to a U.S. organization with 501(c)3 tax status as a charitable, scientific, or educational organization. A donor may also make a contribution to purchase a dollar-denominated debt on the secondary market, which is converted by the debtor nation into its currency for use by the non-profit organization for projects in country. The U.S. organization will need a partner institution in the host country which assures that the activities meet the definition of charitable activities.

Debt donations may yield public relations value, eliminate exposure in a particular country, and help recoup U.S. taxes paid on interest arrearages. While banks express interest in donating "debt for nature" to preserve tropical forests and "debt for education" to assist international programs by U.S. universities, there have been few actual donations to date and prospects for major donations are at best uncertain in the short term.

Clearly, existing tax regulations do not promote donations of bank-held LDC debt. Internal Revenue Service Revenue Ruling 87-124 clarifies procedures for debt donation. For tax accounting purposes, such donations receive the same cash-flow treatment as loan write-offs. However, banks can eliminate exposure by selling debt for cash and take a tax loss on the difference between their tax basis on the debt and the amount they realize from the sale. Sales of debt benefit banks more than outright donations since banks receive cash as well as tax write-offs on losses.

In addition, the IRS has no set formula for valuation of debt; it looks at each transaction individually. However, it may be willing to comment on the acceptability of a valuation in a private letter ruling.

A debt-for-donation transaction may involve both a donation and a loan write-off. The bank may take a tax deduction for a charitable contribution for the fair market value of local currency given in exchange for a hard currency debt, and take a loan loss on the remaining balance. If the full face value of the external debt is paid in local currency equivalent, it may be possible for a bank to claim a tax deduction for the full donation at the face value of the loan, rather than its discounted value on the thin secondary market.

## Debt for Development

Debt-for-development combines major elements of the concepts behind debt for equity and debt for donations and presents a number of opportunities for not-for-profit organizations, including: "debt for nature", "debt for education," and debt for human development through such programs as child immunization. Debt for development allows not-for-profit organizations and debtor nations alike to leverage existing resources to promote development.

Debt is purchased by a not-for-profit organization at a discount in the secondary market or directly from a creditor and converted into local currency. Proceeds are used by the U.S. organization to finance a development project in cooperation with a local development organization or foundation.

The approach may involve pooling arrangements, enabling a number of not-for-profit organizations which have ongoing activities funded with local currency to combine their limited dollar resources to amass enough for a debt conversion transaction. Pooling arrangements are attractive to banks and host governments since larger sums result in a better exchange rate for converting from dollars to local currencies than small transactions. So far, there have been no such pooling transactions; however, efforts are underway for such an arrangement in Brazil.

In conceptualizing a proposal, not-for-profit organizations should not dwell on such issues as debt valuation or inflationary implications. If host countries and commercial banks are interested, they will be primarily responsible for working out those parameters.

## Debt for Debt

Straight debt-for-debt conversions allow exchanges of one type of debt for another or the debt of one country for that of another (e.g., Polish for Brazilian) and usually apply to creditors' seeking to diversify their portfolios or reduce their loss exposure.

Debt-for-debt conversions for development by may have potential for encouraging banks to shift from a nonperforming debt with little chance of repayment to a priority development project with a much better likelihood of ultimate repayment. Banks may thus gain better repayment prospects as well as some slight financial advantage if a host government deems the development activity to be of high importance and provides a more favorable discount rate. Investments in home mortgages generally have higher prospects for repayment than other types of loans and frequently are a social priority for developing nations.

A debt-for-debt swap has been undertaken for cooperative housing in Chile; several similar initiatives are underway to finance low-cost housing in Latin America. Investors would be permitted to exchange local currency mortgages for dollars after several years to recoup their investments. Ultimate repayment in dollars, of course, depends on the availability of foreign exchange to the host government.

## Debt for Bonds

In 1988, commercial banks exchanged external claims on Mexico for bonds of lesser face value but with guaranteed principal (but not interest). The U.S. Treasury issued zero-coupon bonds, which Mexico purchased, to facilitate the transaction. As a result, Mexico retired $3.7 billion in debt.

The Brady Program calls for greater use of the debt-for-bonds technique, which provides for the International Monetary Fund, The World Bank, other multilateral development banks, and their related agencies to provide financing or guarantees to help countries buy back their debts from commercial banks at a discount.

Debt-for-bond conversions have the potential to assist development if development organizations and others successfully can convince policymakers to adopt various tax preferences for banks or other creditors who are willing to donate or participate in debt-for-development transactions. However, as used in the Mexican situation, debt for bonds can drive up the secondary market price and reduce opportunities to fund debt-for-development activities. These types of debt conversions may hurt prospects for use of debt for development.

# WHERE TO BEGIN

Nearly all not-for-profit organizations involved in international development are interested in expanding their resources. Many see debt for development as a means of increasing local currency resources needed for development activities. Some organizations may want to further explore specific ideas or transactions.

A number of consulting firms and not-for-profit organizations are willing to assess debt-for-development opportunities. Often working jointly with LDC counterparts, they will discuss concepts or proposals with central banks. Experienced international bankers who undertake debt conversions will advise on the merits of a proposal.

One of the first steps in undertaking a debt for development program or deciding if the current or proposed activity is appropriate for a debt-for-development transaction is to look at a specific developing country's debt situation. Assess whether the debt is available for purchase and what it will cost to acquire.

Countries with a large percentage of their debt owed to commercial banks and other private institutions are good candidates for debt for development.

In identifying countries for debt-for-development projects, it is helpful to choose those with governments supportive of the concept. A number of countries have debt conversion mechanisms in place and officials trained to handle transactions. Many governments do not have formal programs, but are willing to consider projects on a case-by-case basis.

While there is no single source of information, an informal network has grown up to share debt-for-development experiences both in developed and developing countries. Not-for-profit organizations can benefit from the experiences of earlier development-related debt conversion projects.

When considering a project, a not-for-profit organization should look to strong counterpart organizations which can aid in negotiating with government decision makers, assist in executing the debt conversion, and help implement the project. Debt for development involves strong technical skills for project execution and its application is not appropriate for high risk development activities or experimentation.

The following countries represent a short list of opportunities for debt for development: Argentina, Bolivia, Brazil, Chile, Costa Rica, Ecuador, Hungary, Jamaica, Madagascar, Mexico, Nigeria, Peru, the Philippines, Poland, Yugoslavia, Venezuela, Zambia, and Zimbabwe.

## The Initial Step

The central bank of a debtor nation is key to any debt-for-development project. In most cases, the conversion will be implemented through the central bank, which also will determine what discount rates will apply when hard-currency external debt is liquidated using its own currency. A country might be willing to convert external debt into an equivalent amount of local currency at the prevailing foreign exchange rate. In other cases, the government will discount the value, providing only a certain percentage of the full face value.

Several debtor countries already have a policy and process in place for debt-to-equity conversions. While such policies may not have been created with not-for-profit, debt-for-development applications in mind, the possibility of adapting them for debt for development can be explored with the central bank.

In evaluating debt conversion proposals, a central bank will reflect its own priorities and those of the government. Generally, projects which bring in additional foreign investment, generate foreign exchange earnings through increased exports, or reduce imports are most likely to win central bank approval. However, programs that support social objectives such as low-cost housing, education, and public health are also seen as important.

In seeking a commercial bank as a joint venture partner, leaders of development organizations need to think in terms of projects where the bank will feel comfortable -- usually where the bank has expertise germane to the project. Commercial banks have been most interested in debt-to-equity conversions involving financial firms or in production activities where they have developed in-depth knowledge.

Some examples of possible development projects include development around a nature park or other conservation areas, promotion of micro-enterprise, nontraditional exports, and tourism. A central bank may be receptive to projects which do not reflect its domestic economic priorities if there are convincing arguments for social and/or economic benefits. Local organizations should be enlisted to help "sell" such programs to their central banks.

A central bank naturally will be concerned with the inflationary potential of a conversion project and will seek ways to reduce local currency creation and make the monetary impact manageable. A central bank also will proceed with caution on any project until it can evaluate other potentially negative impacts on the local economy, including upward pressure on interest rates, saturation of the domestic market, and possible distortion in distribution of resources. The central bank will want to assure that debt-for-development programs are consistent within its overall external debt renegotiation strategy.

Not-for-profit organization leaders must take into consideration the debtor country's exchange controls and repatriation policies. Some central banks may require that debt-for-development funds represent "additionality." That is, the funds may not be a substitute for money which normally would be provided by developmental agencies such as AID, or investments that would have been made even if a debt-to-equity program did not exist.

In presenting a proposal to a central bank, one should be aware of the relationship between the central bank and other government offices. If needed and if feasible, enlist the support of those ministries in explaining the project and obtaining central bank approval. Patience is a virtue in the debt conversion process. While project approval may be relatively quick and pro forma in countries with established debt conversion mechanisms, the process is apt to be longer and more complicated in debtor nations without a formal conversion program or where the project is particularly innovative or outside established parameters.

Given that economies of scale are a factor in debt conversions, central banks may look more favorably on proposals involving a relatively large investment. This could be achieved by pooling the resources of several organizations or combining several projects to enlarge the size of a specific transaction.

## Getting a Banker's Perspective

Early in considering a debt-for-development activity, the organization should consult informally with U.S. or other banks familiar with debt conversion transactions. This is important both for simple transactions on the secondary market where the not-for-profit organization is bringing its own money to the table as well as in seeking investors for a debt-to-equity swap for development purposes.

Often a phone call to the bank officer who handles troubled international debt or to an officer of the correspondent bank located in the developing country can save substantial effort. These bank officials can give an indication of whether a transaction should be pursued and what the exchange and discount rates are. Later, the organization will want to return to the bank with more details and begin the process of seeking an investor for the transaction.

The organization should view the transaction from the banker's perspective. Banks holding debt have several options, including:

- selling debt on the secondary market for immediate cash,
- holding debt in the expectation that it will be serviced and repaid in full,
- retaining the debt under rescheduling arrangements because *pari passu,* or burden sharing, clauses do not encourage secondary market activity,
- converting debt to equity in new projects,
- donating it to a charitable organization, and
- writing off debt as uncollectible.

Through informal networks, a not-for-profit organization can identify the banks and other private firms holding debt of the targeted country. They will usually have the broadest base of information. They will be able to provide information on their own bank and other creditors' level of interest in a proposed project. Generally, informal discussions should be held before developing a full-blown project plan. The initial reaction of bankers may provide an immediate evaluation of a project's feasibility or a better understanding of the information and analysis vital to the transaction.

In presenting a debt-for-development project to a bank, keep in mind that:

- banks are profit-oriented,
- they must meet regulatory, safety, and soundness criteria, and
- they are generally risk-adverse and will be most receptive to ideas that involve their areas of product and geographic expertise and clients they already know.

While banks tend to be conservative, they are deal-driven and open to proposals with good profit potential. In addition, banks' interest in a debt conversion project is likely to be higher where the return on the new investment is marginally better and the risk lower than holding existing loans, or where the return is about equal but repayment is expected sooner.

Another factor in a bank's equation is the projected time it will take to realize a return on its investment. As a rule, banks will not consider a project unless it will be profitable within five to seven years. Not-for-profit organizations should look for projects with the cash flow to provide a quick pay-back to the bank, such as food exports to the United States which will yield cash at the time of sale.

There are numerous benefits from having a bank directly involved in the development activity, including expertise, influence, and an understanding of technical and financial details such as conversion costs and risk evaluation.

Of course, a bank will look closely at what the other participants in the deal are bringing to the table, primarily demanding:

- expertise,
- cash to back up a commitment,
- shareholders' rights in an equity investment, and
- a clearly defined cash-out or exit strategy.

Services are available to assist in the process of dealing with commercial banks, including specialized firms, investment banks, and accounting firms. Some multilateral development institutions such as the International Finance Corporation of The World Bank may be willing to provide assistance or even invest funds in some projects. However, the not-for-profit organization should first acquire a basic understanding of the proposed conversion transaction to assure itself that such service providers are acting in its best interests.

## Investors and Other Sources of Funds

Commercial banks hold the bulk of private debt obligations. However, other corporations, such as insurance companies and other financial services companies, trading firms, and manufacturers also hold much debt. Many firms also hold local currencies which they might be willing to sell at a discount.

Not-for-profit organizations should identify potential investors with an interest in the country where the project is to be implemented. These could include:

- **Multinational corporations willing to contract with a local corporation or affiliate simply to sell them a service or product for a set price.**

  Because such corporations usually have solid expertise and financial resources, banks tend to view projects involving multinationals as less risky.

- **Multinational corporations willing to invest in either projects related to their product ingredient needs or counter-purchase requirements.**

  Many developing nations require complex "counter-purchase" arrangements under which a foreign vendor must purchase local products. A commercial bank or accounting firm may be helpful in identifying exporters with counter-purchase requirements.

- **Private sector businesses, including cooperatives, in the developing country which are able to leverage existing resources through the conversion process.**

  Such groups may be able to contribute land or working capital to the project. They may enter into joint proposals which bring additional resources that will strengthen a proposal.

- **Bilateral donor agencies such as AID or the Canadian International Development Agency (CIDA) that are willing to convert development assistance dollars to obtain local currency programs.**

  For example, CIDA financed a $1 million low cost housing project in Jamaica; The Netherlands' assistance agency used the debt swap mechanism to finance tropical forest preservation in Costa Rica, and AID under-

took a debt swap for a nature park in Madagascar. Usually, recipient governments are unwilling to give up hard currency foreign assistance earmarked for their country, but most donor agencies have discretionary funds which can be used in such swaps.

- **Multilateral development banks such as The World Bank or the Inter-American Development Bank (IDB).**

  The IDB is considering launching a major debt swap program to support child survival programs.

- **Not-for-profit organizations willing to use their own resources in joint activities.**

## The Deal

It is not difficult to come up with ideas. Most local development organizations in debtor countries have long lists of projects they would like to undertake. The difficulty is in evaluating the commercial viability of ideas and packaging the project.

To start, a country survey can help in formulating projects for presentation to potential investors. For example, an international cooperative organization identified an extensive list of investment opportunities in the Philippines, as well as banks with an interest in debt conversions.

Opportunities may arise from personal contacts, especially those resulting from previous development activities in a particular country. For example, a U.S. cooperative housing organization, working with Citicorp, was able to arrange an AID guarantee for a cooperative housing project in Chile. Using a currency swap, the Chilean group obtained a special $5 million AID-guaranteed credit to be used by the private nonprofit sector to build 4,000 low-income housing units. This project was based on a decade of collaboration between Chilean and U.S. housing cooperatives.

In putting together a deal, the not-for-profit organization will need to review initial discussions with the host country central bank and a potential commercial bank which will broker the deal. These discussions will uncover issues crucial to structuring the transaction.

The U.S. organization should not undertake a full project development and feasibility plan. Rather, the organization should develop a concise project paper which can be used by the broker in seeking an investor or party who may be interested in a debt swap.

The document should include the following:

- The proposed activity.
- Background and track record of the U.S. organization and its experience in the debtor country.
- The local counterpart's background and relationship to the U.S. entity.
- A summary of the project's priority within the country's economic and development priorities, including comments from key ministries or others. (Identify whether the project is a foreign exchange earner or meets a social or economic priority.)
- Brief project description including a simple budget with cash flow projections. (Foreign and local contributions should be detailed, for example, the provision of land, downpayments in the case of a housing project, costs of management and local investment.)
- Address up front any special risks associated with the project. (For example, environmental concerns relating to the activity or the competitive market should be explained.)
- Detailed, open information on the organization's financial situation and its ability to handle risks should be provided.
- The project should demonstrate at least as good a rate of return for the holder of the debt as its current investment. (There may also be collateral benefits for an investor; for example, the bank involved in the transaction may obtain a priority position for export financing transactions related to the project.)

After the proposal has interested potential creditors who hold debt in the country eligible for a debt swap, the not-for-profit organization will likely have to develop a full project proposal and feasibility plan. This plan may not be required until the potential debt transaction is closer to implementation.

# THE CONVERSION PROCESS

Once a viable project has been worked out, the first step in the conversion process is approval of the central bank and, if required, other governmental offices such as the planning or finance ministries. Once approved, the financial details of the project should be reviewed with an internationally-oriented broker or accounting firm with in-depth knowledge of the process. Such an organization may be able to help identify a bank or other seller of appropriate debt. It may also verify the eligibility of the particular debt for conversion.

The intermediary or broker will approach the various players in the secondary market who hold debt in the particular country. The broker will discuss the financial details of the transaction and obtain an indication of interest in a particular transaction and, if so, on what basis and at what cost.

A key consideration in selecting a creditor holding debt is to assure that safeguards are included in the transaction to limit risk and assure competitive costs. Brokers are in the business of making money from debt swaps. They charge different rates for different transactions and customers, depending on the value brought to the deal. Not-for-profit organizations may be able to share in the financial benefits of the transaction. Usually, this will involve a percentage of the increased value of the debt conversion transaction.

Another important factor to consider is the time it takes for a transaction. In countries such as Brazil with established programs and an active secondary market, a transaction can take only 24 or 48 hours. In other countries, it can take substantially longer. Such a delay in the transaction involves greater risk.

Debt swaps are usually handled on a cash basis. Once the broker has identified the source of debt and is ready to undertake the deal, the broker will request payment of the dollar amount up

front. By requiring cash, the broker eliminates credit risk – the possibility that once the debt is purchased, the client cannot come up with the dollars. This risk can be reduced through a simultaneous transaction or the use of options.

Often, the minimum dollar transaction will be set at $500,000. Larger transactions are of more interest to the central bank and other parties in the transaction. Thus, a number of not-for-profit organizations may want to enter into a pooling arrangement.

In arranging a pooled transaction, all necessary information would need to be gathered from participants, including the amount of converted funds required, the schedule on which the money will be needed and where the converted funds are to be placed (e.g., bank account). Several banks have expressed a strong interest in pooling arrangements which potentially could involve U.S., European, and other not-for-profit organizations undertaking development work in a given country.

The not-for-profit organization and/or investor transfers funds to the broker, which will purchase the debt on its behalf. The broker will arrange with the central bank to transfer the local currency equivalent into a designated local account. At this point, local currency funds will be available for the project activity. All three steps in the conversion process can be executed simultaneously to minimize risk.

Documentation for such transactions is extremely important. In virtually all transactions, lawyers are involved representing all parties to the transaction. Fortunately, the required documentation has become increasingly standardized.

To summarize, the typical steps of a debt conversion transaction are:

1. The not-for-profit purchaser (development organization) obtains project approval from the host country's central bank and other appropriate officials. This approval may be arranged by the broker, local affiliate or not-for-profit, in-country partner.

2. The not-for-profit organization discusses the financial details of the approved project with the broker and executes a letter of intent.

3. The broker identifies a source (seller) who is willing to sell the appropriate debt.

4. The broker verifies with the central bank that this particular debt is eligible for conversion.

5. The not-for-profit organization transfers dollars to the broker which, in turn, purchases the debt.

6. The broker notifies the central bank that the transaction is completed and requests the central bank to transfer the local currency equivalent to a local bank account designated for the in-country not-for-profit partner.

7. Local currency funds are now available for development uses in accordance with an agreement between the development organization and its local affiliate or development partner.

If funding is provided by a donor agency such as AID, there will be an extra series of steps to gain approval of that agency and possibly its in-country representative. If the activity is an on-going project, approval may be required only for that portion of the donor's dollars which will be converted.

# CONCLUSIONS

Debt for development benefits debtor countries, the United States, U.S. and local not-for-profit communities, and citizens of developing nations through strengthening developmental programs and spurring economic growth. Debt conversion is not a panacea. But, it does have the potential for reducing a sizable percentage of a developing country's debt.

Through debt for development, overall hard currency payments required of debtor countries to service external debt can be reduced using payments made in local currency. Debt payments go toward projects that enhance economic development, training, and conservation -- which, in turn, will generate capital, better housing, health services, education, and other improvements in the quality of life.

For banks and other holders of debt, debt for development can reduce arrearages on interest payments and increase the ability of countries to repay their remaining outstanding debt. It also is a way to reduce overall debt, not through forgiveness, but for constructive projects.

For not-for-profit organizations, debt-for-development programs can stretch limited funds for development activities and provide opportunities for strengthening programs in countries which receive little or no foreign assistance, such as Brazil, Mexico, or Chile.

Debt conversion provides a way to increase resources available for accomplishing development objectives in partnership with indigenous organizations. Debt for development provides a means of linking U.S. and local not-for-profit organizations for the purpose of people-to-people development assistance.

Through the use of long-term bonds and local currency endowments, debt for development can represent a new approach to development to provide income streams over 10 or 20 years for

sustainable non-for-profit development activities. These funds can support recurrent costs of development such as educational endowments, maintenance of health clinics, and strengthening conservation reserves to protect endangered species.

Many factors point to the deterioriation of Third World nations' economic situations and underscore the need for an intense application of a new strategy to gain control over the international debt crisis.

Involving the not-for-profit community in development programs channels assistance to the grassroots, where funds can be used to build local enterprise. People-to-people efforts can emerge from capital gridlocked in stalled debt payments. Converted for new opportunities, these funds can signal the beginnings of investments in the future.