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Basic Guide to Using Debt Conversions

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Productive Sector Growth and Environment Division
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Contents

Foreword

Since Congress established the Development Fund for Africa (DFA) in 1987, the U.S. Agency for International Development (USAID) has been challenged to scrutinize the effectiveness and impact of its projects in Africa and make needed adjustments to improve its development assistance programs. Structural Adjustment programs have been adopted by many sub-Saharan African countries — often with reluctance — and some significant economic development progress has been made.

As donor agencies face severe cutbacks and restructuring, and less assistance becomes available to developing countries (not just in sub-Saharan Africa), new ways must be found to channel declining resources to new institutions their most effective and productive uses. Donor agencies like USAID, therefore, are increasingly looking to institutional arrangements in the agriculture and natural resources management sectors to sharpen competitiveness, with agriculture as the dominant sector of sub-Saharan African economies and the potential catalyst for generating broad-based, sustainable economic growth.

The USAID Africa Bureau's Office of Sustainable Development, Productive Sector Growth and Environment Division (AFR/SD/PSGE) has been analyzing the Agency's approach to the agricultural sector in light of the DFA and recent experiences of sub-Saharan African countries. This publication reflects some of these efforts.

This publication is part of a Sustainable Finance Initiative (SFI) Series.* The intent of this publication series is to make information and lessons more broadly available regarding innovative financing mechanisms and sources. The audience for the SFI series is practioners in Africa, including USAID Field Missions, African organizations attempting to develop new mechanisms, African funding agents, and other donors, as well as firms and individuals providing technical assistance to these groups.

The SFI makes available, in traditional print form as well as electronic versions, this publication as well as several others. The primary purpose of this series is to provide those interested in sustainable finance with a set of information resources that:

- describes the principles and tools of sustainable finance;
- provides up to date examination of case examples of sustainable finance;
- reports on meetings that discuss sustainable finance; and
- presents SFI program activities and results.

The SFI is a joint effort of the World Bank, USAID, and two multi-donor bodies — the Special Program for African Agricultural Research (SPAAR) and the Multi-Donor Secretariat (MDS). The SFI aims to help build capacity through focusing on African agriculture and natural resource management agencies. The SFI works with these African agencies to help create new — and more sustainable — mechanisms and sources of funding for national needs and initiatives.

To make this publication series most effective, the documents are written not only to accommodate the point of view of the African institutions undertaking sustainable finance programs, but also from the viewpoint of governments, potential funders, and other stakeholders. Thus these publications can be used as part of the efforts of agriculture and natural resources management institions to build coalitions and to inform stakeholders about the "art of the possible" in sustainable finance.

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* A list of the anticipated publications in this series can be found on the inside front cover of this report.

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Melvin Blase, Jere Gilles, Nicholas Kalaitzandonakes, Michael Nolan, and Ken Pigg of the University of Missouri-Columbia collaborated on this project, and their assistance is greatly appreciated. Graduate assistants Dan Gordon and Leonie Marks provided key research support.

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This guide would not have been possible without the extensive cooperation of Financing for Development, Inc (FFD). The author is especially grateful for the kindness and generosity of John B. Ross, the president of FFD. Although FFD provided much of the information on debt conversions, the author assumes full responsibility for any errors that may be contained in this guide.

Executive Summary

WHAT IS A DEBT CONVERSION?

A group promoting an agricultural or environmental goal by using hard currency to buy discounted debt from an international creditor. The debt is then delivered to the financial authorities (Central Bank and/or Ministry of Finance) of the debtor country, and is retired. In exchange, the financial authorities provide local currency to the organization to be used within the country. The amount of local currency that the financial authorities provide is greater than the equivalent amount of hard currency paid by the organization for the debt.

WHY USE A DEBT CONVERSION?

The organization gains additional funds for its programs, and the debtor country reduces its debt and improves its agriculture or environment.

WHEN CAN A DEBT CONVERSION BE USED?

The organization needs to have access to hard currency, whether from within the institution or from a donor. The country has to have eligible discounted debt, and be open to having the research or conservation activity occur within its borders, and going through the debt conversion process.

QUESTIONS THAT ARISE

The applicant organization may be wary of unfavorable changes in exchange rates or of the debtor government not following through. The organization might also need details of administrative and transaction costs. A recent study shows that while total transaction costs rise with greater benefit amounts, cost per dollar declines.

The debtor government may worry about generating inflation, or of having the resources to pay the organization. Also, the government may need to make provisions against "roundtripping"; taking local currency from the conversion, immediately converting it to hard currency, and leaving the country. Some countries may be concerned about "additionality"; generating the same amount of funds that were already available from the donor. Or the debtor government may want to ensure that the additional funds generated by the debt conversion will be well used.

Debt conversion is merely a financing mechanism. It is one option to look at as part of careful financial and project planning.

HOW DEBT CONVERSION CAN BE EASIER

Some debtor governments devise formal debt conversion programs with guidelines. These guidelines might include:

- Types of projects to be supported
- Financial terms, such as the amount to be paid in local currency and the schedule for disbursing the funds
- Exchange rate
- Application and review procedures

As with any financial transaction, there are transaction costs. Good planning can reduce these costs.

WHAT TO DO FIRST

Outline your project with a detailed budget and investigate sources of funding. Find experts who can handle the complex financial and legal issues. A professional intermediary can locate eligible discounted debt at the best price, negotiate with the debtor government, and manage the transaction.

Glossary of Acronyms and Abbreviations

CBN	Central Bank of Nigeria
DDC	Debt-for-Development Coalition, Inc.
FFD	Financing for Development, Inc.
MUCIA	Midwest Universities Consortium for International Activities
NGO	nongovernmental organization
USAID	United States Agency for International Development

1. How to Use This Guide

What are debt conversions? How can they be used to finance projects? In this guide we will look at how those striving to improve the agriculture and environment of Africa can utilize this funding method to accomplish their goals.

WHO CAN BENEFIT FROM THIS GUIDE?

Groups working in agricultural research and in conservation can use debt conversion to increase project funding. Other governmental and nongovernmental organizations (NGOs) may also find this guide useful. Some sections address the concerns of African Central Banks and Ministries of Finance. The reader does not need to have any prior knowledge of debt conversion.

WHAT IS IN THE GUIDE?

Chapter 2 explains the basics of debt conversion, and describes who participates and why. This section also lists what is required of an organization planning to use this financing method. Part II will help the reader decide whether debt conversion is a suitable option for his or her organization.

Chapter 3 details the procedure that the organization and the debtor government need to follow. This section provides what the reader needs to initiate a debt conversion.

Appendix A summarizes several recent debt conversions in Africa. Appendix B defines terms that may prove useful for doing additional research and for communicating with bankers. Appendix C lists additional resources.

2. Introducing Debt Conversions

WHY ARE DEBTS AVAILABLE FOR CONVERSION?

During the late 1970s and early 1980s, developing countries acquired great amounts of debt to finance deficits created by high oil prices, adverse terms of trade, increasing interest rates, and falling commodity prices. External debt grew from $46 billion in 1972 to over $300 billion by August 1982 (Boehmer and Megginson 1990, 1518). In Sub-Saharan Africa, payments to service the external debt rose from 15 percent of export earnings in 1980 to 31 percent in 1986 (Chase 1991, 373). Many indebted countries found it increasingly difficult to meet their debt payments and, beginning with Mexico in 1982, over 40 developing countries have defaulted on loans and have been forced to reschedule debts with commercial banks or to find other means of relief (Sachs 1986, 397).

In the beginning of the debt crisis, financial packages for restructuring debt emphasized new lending to allow time for indebted countries to resolve their debt servicing problems. However, after several years, few countries were returning to normal debt servicing and further financing was becoming more difficult (Clark 1993, 38). In 1989, U.S. Treasury Secretary Nicholas Brady proposed a plan for restoring the creditworthiness of debtor countries through individualized packages of market-based debt and debt service reduction mechanisms. Among the debt reduction options offered in the Brady Plan are debt conversions. Although debt conversions had been used in the past by private firms, they were not used by debtor governments or NGOs until Lovejoy first suggested their use in 1984 as a means of using the debt crisis to improve environmental conservation and natural resource management.

HOW DOES A DEBT CONVERSION WORK?

First, an organization with hard currency purchases the outstanding discounted debt of a country; a debt on which the country has fallen behind. The debt is sold for less than face value because the creditor is not confident of collecting the full amount. For example, a debt with a face value of one million U.S. dollars might be discounted to 20% of its face value, or US$200,000.

Then the organization delivers the debt to the debtor government. It is considered retired, no longer owed to anyone. In exchange for the debt, the debtor country provides the organization with a specific amount of currency to be used for the organization's project within the debtor country.

What makes a debt conversion attractive is that the amount of local currency for the applicant organization's project is significantly greater than the amount the organization paid for the debt.

WHO PARTICIPATES IN A DEBT CONVERSION?

Applicant Organization

This institution purchases the debt and delivers it to the debtor government. It may be involved in agricultural research, conservation, or any of many public-interest activities within the debtor country.

Sometimes a donor is also involved. Either the organization that will handle the project or the donor can serve as the applicant organization.

Figure 2.1. Example of a Debt Conversion

1 Applicant organization pays US$200,000 to purchase a debt with face value of US$1,000,000.

Creditor ← US$200,000 ← Applicant Organization

Creditor → Debt Note with Face Value of US$1,000,000 → Applicant Organization

2 Applicant organization delivers debt to financial authorities of debtor country. In exchange, debtor country provides local currency equivalent to US$300,000.

Debtor Government ← Debt Note with Face Value of US$1,000,000 ← Applicant Organization

Debtor Government → US$300,000 (in local currency) → Applicant Organization

Applicant Organization ↕ US$300,000 (local currency) ↕ Project

Applicant organization now has an extra US$100,000 in local currency.

Debtor Country

The country's central bank, finance ministry, or planning ministry handles a debt conversion. Some countries have a debt conversion unit within the appropriate department. There may even be a formal program for soliciting applicant organizations and handling the procedure. However, it is always the applicant organization that initiates the conversion.

Creditor

Although the creditor may be the financial institution that originally made the loan, that institution has usually sold the debt into the international secondary market that buys and sells such loans at below face value. The creditor, therefore, that participates in loan conversion is often not the creditor that originated the loan.

Generally the creditor is a private organization, such as a bank or trading company, but it may be another government. Increasingly in Africa, countries are conducting bilateral debt conversions, often using loans held by Paris Club export credit agencies such as ECGD in the United Kingdom or the Office National du Ducroire in Belgium.

Often the applicant organization or the debtor country hires a fourth participant—a professional intermediary to handle legal and financial issues. Some of the largest international organizations have developed this expertise in-house.

WHO BENEFITS AND HOW?

Applicant Organization

The applicant organization has additional funds for its programs in agricultural research, conservation, or other development or relief work. A donor organization, if one is involved, makes more progress towards its goals than if it simply donated the original hard currency, since the debt conversion adds to the funds available.

Figure 2.2. Government Offices Responsible for Debt Conversions

Ghana	Ministry of Finance
Kenya	Ministry of Finance
Madagascar	Ministry of Finance
Mali	Ministry of Finance
Nigeria	Central Bank
Senegal	Ministry of Finance
Tanzania	Central Bank
Zambia	Central Bank

Debtor Country

The debtor country reduces its external debt. The government can then decrease its debt service payments and improve its standing in international credit markets, permitting the country to have greater access to future loans on more reasonable terms. The debtor country also benefits from the development and conservation projects the debt conversion generates, especially if these projects are in line with the government's priorities.

Creditor

The creditor receives some payment from an outstanding, questionable debt. The loan holder benefits more from a higher price paid for the debt, so price is, of course, carefully negotiated between creditor and applicant organization.

Blocked Currency Conversions

Blocked currency is local currency, usually held by international corporations, that can not be converted to hard currency and removed from the country due to host government restrictions. In a blocked currency conversion, the donor or applicant organization uses hard currency to buy the blocked currency at a discount. The blocked currency is then used to support a project within the host country.

WHEN IS A DEBT CONVERSION FEASIBLE?

If an organization answers "yes" to the following four questions, it should strongly consider initiating a debt conversion. If an answer is not known, the institution may want to do additional research.

1. ***Is the project acceptable to the debtor government?*** Does it match the government's priorities? Some countries have formal debt conversion programs that specify which types of projects are eligible. The organization needs to have already clarified the project's objectives, methods, timetable, and budget. Under some formal debt conversion programs, an applicant must stipulate the program's cash flow needs.

2. ***Is the hard currency available?*** The hard currency, which may be from a donor, needs to be on hand when initiating a debt conversion. The amount needed depends on the magnitude of the project, the current discount rate for the debt, and the amount the debtor government is willing to pay to retire outstanding debt. Of course, the applicant organization will proceed only if the funds generated for the project will be greater than the original amount of hard currency.

3. ***Does the country have eligible discounted debt?*** Some of the country's debt must be available for purchase at less than face value. It must also be free of restrictions that prohibit it from being converted. Or an applicant organization can use a country's blocked currency (see box).

4. ***Is the debtor government willing to participate?*** Has the country undergone debt conversions in the past? Does it have a formal debt conversion program? An organization can informally look into the government's interest in this financing method.

If an organization answers "yes" to these questions, it should proceed to the next chapter for more detailed information. The following worksheet provides space to record and analyze the answers.

Figure 2.3. Debt Conversion Feasibility Worksheet

Is a debt conversion feasible for our organization's project?

Question	Yes/No	Notes/Discussion
1. Is the project acceptable to the debtor government?		
2. Is the hard currency available?		
3. Does the country have eligible discounted debt?		
4. Is the debtor government willing to participate?		

Additional Notes

3. A Guide to Using Debt Conversions

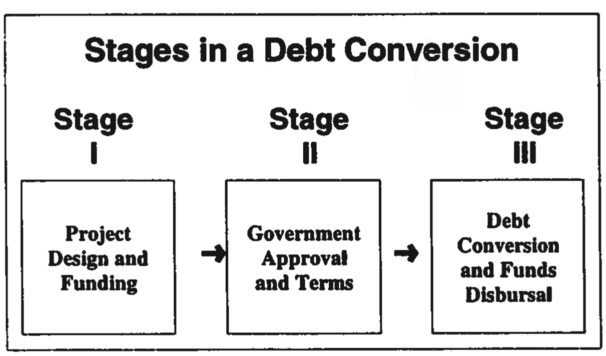
This part of the guide offers a more detailed look at debt conversions. It is assumed that the questions in the worksheet at the close of the previous section have been answered and it has been determined that the use of a debt conversion may be a viable financing option. The next section describes the procedure for completing a debt conversion. In the last two sections, the benefits of participating in a debt conversion are reviewed and the most common concerns of the applicant organization and the debtor government are addressed.

WHAT PROCEDURE IS INVOLVED?

The procedure for completing a debt conversion can be understood as consisting of three stages. In the first stage, the applicant organization must design a project and locate the funds to be used in initiating the conversion. In the second stage, the organization must obtain the approval of the debtor government and negotiate the terms of the debt conversion agreement. In the third and final stage, the eligible debt must be purchased and transferred to the government and the resulting funds disbursed to the project.

Stage 1: Project Design and Funding

Since the 1980s, debt conversions have been used to finance a variety of projects. In general, these conversions are known as "Debt-for-Development" or "Debt-for-Nature." More descriptive terms are sometimes used, such as "Debt-for-Research", to describe a situation in which the funds from a conversion are earmarked for agricultural research. Debt conversions have been used to finance projects ranging from the treatment of River Blindness ("Debt-for-Health") to the establishment of care for AIDS orphans ("Debt-for-AIDS"). These examples illustrate how the money raised from a debt conversion can be used to finance a specific project; nevertheless, it is also possible to use a debt conversion as one of a number of financing mechanisms for the purpose of creating an endowment, or endowed foundation.



It is important to recognize from the beginning that a debt conversion is merely a financing mechanism. It does not substitute for the careful and thorough design of a project. In order to approach a debtor government or a donor with a request to participate in a debt conversion, it is first necessary for the organization to design an attractive project and a realistic budget. In addition, the budget should specify the timing of funding needs, since the proceeds form a debt conversion are often made available in installments over time.

Stage I Activities

√ Design project and budget
√ Locate hard currency funding
√ Confirm support within organization
√ Confirm support of any donor(s)
√ Analyze costs/benefits of conversion
√ Hire intermediary

Hard currency funding must be available to cover at least part of the proposed project budget. While a debt conversion can be used to convert an initial amount of hard currency into a larger amount of domestic currency, it can not be used to generate the entire amount of project funding.

In this initial stage, it is advisable to confirm that the board of directors and key staff within the organization all agree in principle with the use of a debt conversion as a project financing mechanism. This will be particularly necessary if the funds for the conversion will come from within the organization. If funds for the conversion are to be supplied by outside donors, then the donors' willingness to participate in a conversion must also be determined.

At the end of the first stage, a cost-benefit analysis can be undertaken to determine whether it is worthwhile to pursue the debt conversion option in order to finance the project. The principle benefit of a debt conversion would be the premium that is gained. The costs of a debt conversion include the use of staff time and the expenses related to a conversion. These are also known as "transaction costs."

It is often at this point that an organization will hire an experienced intermediary to assist in the conversion. An intermediary can provide technical assistance to the organization in designing and carrying out the debt conversion. The intermediary can also assist in the cost-benefit analysis. The fee paid to the intermediary would be included in the cost-benefit analysis as a cost associated with the conversion.

Stage II: Government Approval and Terms

The participation of the debtor government is an essential ingredient in a debt conversion. The means of obtaining government approval varies across countries, but it will generally involve communicating with the government's financial authorities and completing some type of application. A debt conversion application will usually include information about the applicant organization, the project to be supported by the conversion, and the proposed budget for the project. The more formal the government's debt conversion program, the more uniform are the application procedures. In countries that lack formal debt conversion programs, it may be more difficult to determine the proper procedure to follow.

Stage II Activities

√ Locate government office
√ Follow application procedures
√ Negotiate financial terms of conversion

There are several financial terms in the debt conversion agreement that must be agreed upon by the organization and the government. One important financial term is the size of the local currency proceeds that the government will pay in the transaction. The higher the premium—which is the difference between the price paid for the debt by the applicant organization and the local currency equivalent paid by the debtor government—the more the organization gains from the conversion. A second area for careful negotiation are the terms under which the proceeds from the debt conversion will be disbursed or paid out by the government to the organization. The disbursement terms include both the form (whether cash or bonds) and the timing of the disbursement. Another important term in the debt conversion agreement is the foreign exchange rate to be used.

Stage III: Debt Conversion and Funds Disbursement

The third and final stage of a debt conversion involves completing the actual transaction. First eligible, discounted debt must be located and priced. While this will be relatively easy for countries that have a large amount of discounted debt offered on the secondary market, other countries may have a "thin" market with little active trading. In situations where there is little trading, it may be more difficult to locate debt and determine its fair market price.

Stage III Activities

√ Locate and price eligible, discounted debt
√ Purchase discounted debt
√ Convey debt to debtor government
√ Receive local currency disbursement

The next step is to purchase the eligible debt. It will generally be more beneficial for the organization to purchase the debt with the lowest price (greatest discount). Once the purchased debt has been conveyed to the debtor government, the disbursement of local currency to support the organization's project can take place.

WHAT ARE THE CONCERNS OF THE APPLICANT ORGANIZATION?

We turn now to some of the concerns that the applicant organization might have about participating in a debt conversion. The three most common types of concerns relate to exchange rate risks, doubts about the performance of the debtor government, and transaction costs. These are legitimate concerns and they indicate that caution should be exercised when participating in a debt conversion. By engaging the services of an experienced intermediary, many of these potential problems can be reduced or eliminated.

Debt Conversion from the Perspective of the Applicant Organization

Benefit: Premium Payment

Concerns:

- Exchange Rate Risk
- Government Performance
- Transaction Cost

Benefits

It is worthwhile at this point to review the benefits of a debt conversion to the organization. By participating in a debt conversion, the organization is able to provide a greater amount of local currency to a project than would have been the case if the hard currency available to the organization had simply been exchanged for local currency under a normal exchange rate.

The benefit is generated in the following way: (1) the organization uses hard currency to purchase discounted debt, paying less than the face value of the debt (i.e., the organization buys the debt "at a discount"); (2) the organization delivers the debt to the debtor government; (3) the debtor government "pays" the organization in local currency, with the amount that the government pays being equivalent to the purchase price that the organization paid in step (1), plus some additional amount of money. The difference between the purchase price for the debt and the amount paid by the debtor government (in local currency) is called the premium. This premium payment represents the benefit to the organization of participating in the debt conversion.

Exchange Rate Risk

Exchange rate risk is due to the fact that exchange rates fluctuate over time. It is possible that an organization will hold a large amount of local currency for some time following a debt conversion. If the local currency is devalued or depreciated during this time period, then the benefit of the debt conversion may be reduced (or even reversed). One way to avoid this problem is to arrange to receive the funds in partial payments over time (or "tranches") as resources are needed by the project. The agreement between the government and the organization can stipulate that each payment be pegged to a hard currency equivalent and paid in local currency at the highest legal exchange rate on the day of the payment.

Government Performance and Delays

The organization should carefully consider the reliability of the government in making full payment according to the agreed upon schedule. Information on this reliability may be available by examining the government's performance in previous debt conversion agreements. If the disbursement is to be made in tranches, the balance of the funds can be placed in a trust account as a precaution. A debt conversion agreement should be drawn up as a legally binding agreement so that it is also possible to sue for nonperformance. In the special case in which the applicant organization has little or no autonomy from the central government, such as in the case of an agricultural research organization that is part of a government ministry, then the legal ability to sue for nonperformance may not exist.

Transaction Costs

Transaction costs refer to all of the expenses associated with arranging a debt conversion. These include the time of staff members who work on the conversion, payments to intermediaries, long distance phone calls, legal fees, postal and courier packages, photocopying, and any other expenses related to the transaction. All of these costs act to reduce the net benefit that is received from the debt conversion. For this reason, an estimate of transaction costs should be included in the cost-benefit analysis completed during stage I of the conversion.

Transaction Costs...

⇑ with monetary value of premium
(but unit transaction costs decline)
⇓ for blocked currency conversions
⇓ with experience and repeated transactions

Source: Dunn and Gordon 1995.

While each organization is unique, some general information about transaction costs is available from a recent empirical study (Dunn and Gordon 1995). In a sample of 126 conversions completed by The Debt-for-Development Coalition, Inc., between 1992 and 1994, it was found that while the intermediary's total transaction costs increase with the size of the conversion, unit transaction costs decline as the monetary value of the premium increases.

On average, there were $.03 in transaction costs for every $1 of premium earned. The study also showed that blocked currency conversions have lower transaction costs than debt conversions and that transaction costs decline with experience and decline when an organization, a debtor government, and an intermediary work together on a repeated basis. Formal government debt conversion programs were not found to raise or lower transaction costs, but formal programs did result in a lower average value for the premium paid.

WHAT ARE THE CONCERNS OF THE DEBTOR GOVERNMENT?

If the financial authorities of the debtor government have limited experience with debt conversions, they are likely to have several concerns. This section of the guide is written to address at least some of these concerns. After reviewing the benefits of debt conversions for the government, this section discusses the topics of budgetary resources, inflation, round-tripping, additionality, and policy conditionality. The section closes with a few comments on the establishment by the government of a formal debt conversion program.

Benefits

Debt conversions offer two major benefits to the debtor government. First, the government is able to reduce its external debt obligations without expending any of its scarce hard currency. This reduction in external debt lowers future outflow of the hard currency that would have gone to service the debt. The reduction in external debt can also have a beneficial effect on the country's credit standing. As the country's outstanding debt is reduced, more loans on better credit terms may become available to the country.

A second major benefit of a debt conversion is that it increases the level of spending on development and environmental conservation projects within the country. When these investments are over and above existing donor obligations, they represent an increase in development and conservation assistance. The debtor government, too, is able to contribute to the increased investment in development and the environment by diverting resources toward these causes and away from servicing external debt.

Debt Conversion from the Perspective of the Debtor Government

Benefits

❶ Reduction in external debt obligations
- ➲ eliminate hard currency payments
- ➲ improve credit standing

❷ Increase development and conservation
- ➲ additional donor assistance
- ➲ increased government contribution

Concerns

➲ Lack of Budgetary Resources
➲ Inflation ➲ Additionality
➲ Roundtripping ➲ Policy Conditionality

Lack of Budgetary Resources

One of the government's greatest concerns may be whether it has sufficient budgetary resources to participate in a debt conversion. Even though the government will be paying in local currency, the national budget may not have the excess funds required to pay the debt conversion proceeds. In fact, governments that have participated in debt conversions in the past may have to suspend their programs for this reason. The claim on budgetary resources made by a debt conversion provides an important incentive for governments to negotiate to pay lower proceeds to the applicant organization.

Inflation

Most governments will want to evaluate the potential inflationary impact of participating in a debt conversion. Of course, the larger the size of the debt conversion, the greater the possibility of fueling inflation; small debt conversions represent less of a problem. Countries that already have strong inflationary pressures should exercise caution before undertaking a large debt conversion program.

Measures to Prevent Inflationary Impacts

√ Use taxes or domestic borrowing to finance premium
√ Pay proceeds over a longer time period
√ Pay a lower premium

Several steps can be taken to reduce the potential inflationary impact of debt conversions. First, if the government finances the premium through tax revenues or domestic borrowing rather than by increasing the domestic money supply, the inflationary pressures will be greatly reduced or eliminated. Also, the government can avoid the shock to the domestic economy that results from a sudden large influx of funds by arranging to pay the proceeds from the conversion over a longer period of time. Finally, another measure that the government can take to reduce the inflationary impact of debt conversions is to reduce the amount of premium it agrees to pay.

Roundtripping

Roundtripping refers to a situation in which the domestic currency generated by a debt conversion is reconverted to hard currency and subsequently removed from the country. The amount of hard currency that leaves the country in a roundtrip operation will exceed the amount of hard currency that was originally invested in purchasing the debt. In most cases, the effect of roundtripping is to eliminate the benefit of the debt conversion to the host country. For this reason, most countries will want to prevent this practice. However, there may be some cases in which it is necessary and desirable to use hard currency in order to import products or services that are needed to support the project.

Additionality

There may be some question as to whether government participation in a debt conversion is really necessary in order to encourage the donor to invest hard currency that would not otherwise be made available. The external funds that initiate a debt conversion are considered "additional" if they would not have been available without the debt conversion. In a 1989 study of debt-equity conversions in Latin America, Bergsman and Edisis found that debt conversions did bring in additional investment.

If funds are additional, then all of the benefits of a debt conversion apply. If funds are not additional, then the government has used its scarce resources to subsidize a project that would have been undertaken anyway. While a government may not be able to determine conclusively whether the external funds for debt conversions represent additional investment, one safeguard that a government can use is to establish priorities for development and conservation projects and to only offer premiums on debt conversions that match those priorities. In this way, a government can be sure that it is not using scarce resources to subsidize a low priority project.

Policy Conditionality

Finally, there may be a public perception that debt conversions reduce the sovereignty of the debtor nation by permitting the allocation of government resources to be influenced by external forces. Again, the principal safeguard against allowing debt conversions to unduly influence government policies is for the government to establish its own priorities and to follow these priorities when evaluating applications for debt conversions. The establishment of government priorities is one of the features of a formal debt conversion program.

Policies for Formal Debt Conversion Programs

- Application and Approval Procedures
- Priority Projects to be Supported
- Financial Terms: Premiums and Disbursement

Formal Debt Conversion Programs

A government may wish to establish standard procedures for participating in debt conversions. The box at right lists a number of the characteristics of debt conversions that can be established through a formal program. A formal program helps the government to protect the country against the potential disadvantages of debt conversions.

It is hoped that this guide has been useful in providing the reader with an introduction to the subject of debt conversions and his or her use in financing projects such as agricultural research and environmental conservation. This guide is not intended to replace professional financial and legal advice. Rather, the guide should provide sufficient information for the reader to know whether or not to pursue the debt conversion option. In the first appendix, a few examples of recent debt conversions in Africa are described. The second appendix contains a glossary of some of the technical terms used in this guide and in other references related to debt conversions. The third appendix contains a list of useful references on the subject of debt conversions.

Appendix A
Example African Debt Conversions

FORMAL DEBT CONVERSION PROGRAMS IN NIGERIA*

Nigeria became the first African country to establish a formal debt-equity conversion program in February 1988. Although temporarily suspended in 1990, the program was re-instituted in January 1991 and continues as a reliable and efficient alternative to traditional currency exchange. Successful conversions are presently estimated to provide a 30% financial gain over a foreign exchange transaction at the official rate.

The Nigerian debt conversion program is well established and efficient. Most conversions from the time of debt purchase through disbursement of local currency can be accomplished within one month. Prior to an initial debt purchase, the applicant must request the approval of the Nigerian government to authorize the conversion of a global amount of debt to benefit a specific project or program. Initial approval is generally given within one month of the application's submission. Tranche conversions may then be effected up to the total amount of debt authorized.

Conversions by not-for-profit entities operating in Nigeria are officially preferred by the Nigerian government and NGOs are encouraged to apply. Initial application is made by letter to the Central Bank of Nigeria (CBN) and must include the identity of the applicant, copies of the applicant's experience in debt conversions worldwide, a commitment by the applicant to adhere to the Debt Conversion Program guidelines, a project descrip-tion, identification of recipient(s) of the conversion proceeds, identification of local agents and representatives, organizational references, and detailed handling instructions for conversion proceeds.

Then after receiving approval from the CBN, the conversion applicant may participate in monthly debt conversion auctions at the CBN. Mount of naira on offer each month is determined in accordance with macro-economic targets for the monetary system as a whole. Successful bidders then submit debt to the CBN and receive local currency. Approximately one month is required to complete this exchange.

The monthly actions set the discount rate applicable to conversion of debt. Conversion applicants submit bids in which they state how much of the face value principal of the debt they are willing to forego. The highest discount bids offered by the conversion applicants win because they translate into the lowest repurchase price for the CBN. Successful bids are thus ranked in decreasing order with the highest bid favored over the next highest until the total amount of local currency offered for auction is exhausted.

The final step of presentation and payment occurs within fifteen business days of the auction date. Naira proceeds from the conversions are credited to blocked, non-interest bearing accounts maintained at the CBN as soon as the bank has confirmation of receipt of the debt instruments. After deducting a naira fee of 2.5% of the discounted value of the debt, the CBN will disburse the conversion proceeds to the NGO's dedicated commercial bank account. The NGO may then use these naira funds to cover the local costs of its approved project or program.

The Nigerian debt conversion program is especially attractive in its flexibility. For instance,

* This example is reproduced from an information piece entitled "Country Opportunity Series: Nigeria," released by the Debt-for-Development Coalition, Inc. on May 26, 1995.

those applicants not wishing to bid at auction may still convert funds on an *ad hoc* basis. The discount applied to these *ad hoc* conversions is the weighted average of the successful bids of the most recent auction. NGOs with debt conversion authorizations may also conduct their conversion in several tranche installments up to the total amount of debt authorized. In each successive redemption the NGO either submits a new auction bid or applies for permission for an *ad hoc* conversion.

As in any debt conversion, the conversion applicant runs the risk of non-performance by the CBN. To date we are not aware of any debt conversion transaction in which the CBN has defaulted on its obligation to pay naira in exchange for debt instruments. The conversion auction participant also runs the risk of not having its bid accepted. To alleviate this risk the CBN provides information on the discounts offered by successful and unsuccessful bidders at previous auctions. Similarly, as with any local currency holder, the successful NGO bidder holding naira proceeds assumes the risk of hedging against inflation and devaluation. The CBN assists in this effort by allowing redemption in tranches and, when requested, by investing local currency proceeds in interest-bearing bonds or government securities. These instruments are currently estimated to earn interest at between 20% and 25% per annum and therefore lessen the adverse impact of inflation on debt conversion proceeds.

The CBN currently applies a discount of 43.4552% to the face value of debt presented for conversion, and Nigerian promissory notes are presently selling in the secondary market at approximately 35% of face value. An NGO can therefore purchase face value debt of US$285,714 for an investment of US$100,000. Of this face value amount, US$236,066 represents actual loan principal outstanding and eligible for redemption. Conversion proceeds will therefore equal 56.5448% of US$236,066 less the CBN fee of 2.5%. The net proceeds of the conversion will therefore be US$130,146 or Naira 10,307,547. Based on an investment of US$100,000, this transaction therefore produces an effective exchange rate of 103.07 naira per dollar.

DEBT-FOR-DEVELOPMENT IN ZAMBIA*

On September 14, 1994, the Republic of Zambia completed a World Bank-funded debt reduction program. This program will allow Zambia, one of Africa's poorest and most severely indebted countries, to cancel nearly US$200 million of its external commercial bank debt. Included in the debt reduction program was a carefully integrated debt-for-development option that will enable Zambia to generate development funding of approximately US$15 million. Proceeds from transactions completed under the option are presently being disbursed. By including a debt-for-development option in the debt reduction program, Zambia is addressing both sides of a troubling dilemma: a crushing debt burden and an acute lack of development resources.

Under the debt-for-development option, development organizations (NGOs), obtained debt from Zambia's creditors through purchase or donation, which it subsequently exchanged with the government of Zambia for funds to finance development projects. In return for spending the funds on approved development projects in Zambia, the government will pay a 50% premium in local currency to the NGOs. In other words, for every dollar that an NGO invested (or received as a donation) it will receive US$1.50 to spend on development projects. For an initial investment of US$10.1 million, participating groups will receive approximately US$15 million to spend on their projects. In addition, the transactions completed by NGOs will retire over US$92 million (or 23%) of Zambia's external commercial debt.

* This example is reproduced from an information piece of the same title released by the Debt-for-Development Coalition, Inc. in 1994.

Participating NGOs, which include both small Zambian organization and large internationally-recognized groups, such as UNICEF, CARE, Catholic Relief Services and World Vision, will use the funds obtained through the debt-for-development option to fund a wide variety of health, environmental preservation, education, low-income housing, and micro-enterprise development projects. The Debt-for-Development Coalition, Inc. (DDC) provided these organizations with technical assistance in concluding their transactions. DDC, in consultation with Zambia and Zambia's financial and legal advisors, designed and implemented the debt-for-development option.

Prior to the debt reduction program, Zambia's external debt burden consumed 40% of the country's export earnings and presented a major impediment to its social and economic development. At a time when over 50% of Zambia's 9.1 million people are living in poverty, the country's average life expectancy is only 46 years and access to safe water is available to only half the population, Zambia clearly needs all its resources for development. The debt reduction program has enabled the country to turn external debt into internal development resources.

GHANA PROTECTS ITS FORESTS AND CULTURAL HERITAGE THROUGH DEPT SWAPS*

In 1992, Ghana used an innovative debt conversion mechanism to support a unique ecotourism program designed to protect and preserve two of its most important national assets: its natural resources and World Heritage historic buildings. Developed by the Debt-for-Development Coalition, Inc. (DDC), the debt swap program brings together four leading U.S. not-for-profit institutions involved in international development, and environmental and cultural survival activities to assist the Government of Ghana in a tourism development project in its Central Region. Their success is protecting the last remaining tropical forest in the area, and preserving ancient forts and castles once prominent in the slave trade of the region.

The four institutions brought together for the debt-for-ecotourism transactions by DDC were the Midwest Universities Consortium for International Activities (MUCIA), the Smithsonian Institution, Conservation International and the U.S. Committee of the International Council on Monuments and Sites. MUCIA is leading the project consortium.

To protect the environment, the project is creating the Kakum National Park in the Central Region, one of the few remaining rain forests in what was once a tropical rain forest belt stretching across the southern coast of West Africa. Aside from the varied flora of the area, Kakum is believed to contain more than a dozen endangered animal species, including the forest elephant. From an economic perspective, the preservation of Kakum is essential to its current function as a watershed for the Cape Coast area, as well as a potential tourist attraction.

The consortium is assisting Ghana in the preparation of studies of the park's resources, the planning and construction of park facilities, and the training of park scientific and management staff, as well as the marketing of the park and the development of interpretive/educational programs for visitors.

The region is now economically depressed, and stimulation of the local economy through development of the tourist industry can play a major role in relieving pressures on the natural resources of the region. Credit for conceiving, planning and promoting this innovative project belongs to political leaders in Ghana's Central Region who set out nearly three years earlier to find a growth strategy reflecting the unique attributes of the region. The project has already stimulated private sector investments in hotel, food service and resort development. The region also offers unspoiled beaches and good weather as added attractions.

* This example is reproduced from an information piece of the same title released by the Debt-for-Development Coalition, Inc. in May 1993.

An innovative strategy of the program, coordinated by the Debt-for-Development Coalition, has been the leveraging of resources through the purchase and donation of blocked currency. The Ghanian cedis resulting from this transaction are being used to finance the local costs of the project, including restoration of the historic sites, development of the park and preparation of the visitors programs.

To support this effort, DDC completed the first transaction involving the purchase and donation of blocked currency to cancel inter-company debt, generating benefits of about 300%. U.S. Agency for International Development is providing $5.7 million for the project which began in fall of 1992.

Appendix B
Glossary of Terms

ADDITIONALITY - a policy issue concerning whether the investments derived from a debt conversion would not have otherwise been made and are, therefore, additional

AT A DISCOUNT - a price below par or face value

BALANCE OF PAYMENTS - the balance of a national account in which are recorded all international dealings resulting in payments of money during a certain period; unlike the balance of trade which includes only visible dealings (articles of trade, and gold and silver bars and coins), the balance of payments takes note of invisible imports and exports (payments for banking, insurance, transport, and other services), interest payments and movements of capital; the balance is said to be in deficit (adverse, passive or unfavorable) if it shows that the country pays or owes more than it receives or is owed, and in surplus (active or favorable) if the opposite is true

BLOCKED CURRENCY - claims by international corporations that have been blocked due to foreign exchange, investment, or import controls imposed by the host government

BOND - a contract that gives the holder (lender) a claim to a specified stream of payments from the issuer (borrower)

BORROWER - one who borrows cash or buys something on credit

BRADY PLAN - plan proposed by U.S. Secretary of Treasury N. Brady in 1989 to reduce debtor countries external debt by offering a menu of options for restructuring or canceling external debt

BUNDLING - converting more than one debt in a single conversion transaction

CENTRAL BANK - supervises the operation of the nation's banking system and acts to regulate the money supply; typically performs services for other banks, such as providing funds as a last resort; the only bank to issue currency and hold bank deposits to serve as reserves; engages in open market operations to influence the money supply

CREDIT - loanable funds advanced by lenders and held in a bank account for borrowers to draw upon, in return for a promise to pay back the borrowed funds according to an agreed upon schedule

CREDITOR - a person or organization to whom money is owed

CURRENCY - any kind of money that is in general use as cash, passing from person to person, such as coin and bank notes; any generally accepted means of payment; anything used as a medium of exchange such as coins, bank notes, checks, promissory notes, and any document that can be used in place of money

DEBT CONVERSION - a transaction in which the holder of a debt instrument issued by a debtor country exchanges its rights to receive payment under the instrument for something else of value given in return by the debtor country; the parties to the transaction are usually the applicant organization, the original creditor (or subsequent holder of the debt), and the Central Bank of the debtor country; the transaction results in cancellation of the debtor country's obligation to pay the creditor

DEBT-EQUITY SWAP - a debt conversion for the purpose of funding equity investments

DEBT-FOR-EDUCATION - a debt conversion for the purpose of funding education programs

DEBT-FOR-DEVELOPMENT - a general term for a debt conversion for the purpose of funding a development project

DEBT-FOR-ECOTOURISM - a debt conversion for the purpose of funding the creation of tourism businesses

DEBT-FOR-ENDOWMENTS - a debt conversion for the purpose of funding an endowment

DEBT-FOR-NATURE - a debt conversion for the purpose of funding a nature preservation or conservation project

DEBT FORGIVEN/DEBT FORGIVENESS - the amount of principal due or in arrears that is written off (or no longer under obligation to pay) in any given year

DEBT-FOR-RESEARCH - similar to debt-for-education but the funds are used primarily for research purposes

DEBT INSTRUMENT - legal documentation that results in money being borrowed from one entity by another, such as bonds, treasury bills, and government external debt

DEBTOR - a person or organization which owes money to a creditor

DEBT SERVICE - the interest and charges currently payable on a debt, including principal payments

DEBT SWAP - same as debt conversion

DISBURSEMENTS - payments on financial commitments

DISCOUNTED DEBT - a debt instrument that can be purchased at a price less than its face value

DONATED DEBT - debt that is given to a not-for-profit organization by a creditor (rather than purchased from a creditor)

DONOR - an entity that provides material support to a recipient country or organization

ELIGIBLE DEBT - debt that can legally be exchanged in a debt conversion

ENDOWED FOUNDATION - an entity supported by an endowment.

ENDOWMENT - perpetual fund in which a capital base is invested to yield interest

EXCHANGE RATE RISK - risk of financial loss from fluctuations in the real exchange rate occurring between the time of purchase of a debt instrument and its exchange under the terms of the contract

EXTERNAL DEBT - debt that is owed to nonresidents and repayable in foreign currency, goods, or services

EXTERNAL PUBLIC DEBT - an external obligation of a public debtor, including the national government, local or regional governments, and government-owned (parastatal) companies

FACE VALUE - the nominal value of a stock, share, or debt instrument, as distinguished from the market value

FORMAL DEBT CONVERSION PROGRAM - an established program of a debtor government that provides guidelines for debt conversions

FOREIGN DEBT - same as external debt

GRANT - legally binding commitments that obligate a specific value of funds to be available for disbursement and for which there is no repayment requirement

HARD CURRENCY - currency of a country which has a strong balance of payments; currency with strong price and demand, especially in exchange for soft currency

INCONVERTIBLE CURRENCY - currency that is not convertible into another currency

INFLATION - a sustained increase in the general price level over time

INTEREST - the price paid for the use of money such as by a borrower to a lender of money; the money earned by a lender as a payment for allowing the borrower to use the money and for waiting for the repayment of the loan

INTEREST FORGIVEN - the amount of interest due or in arrears that is written off or forgiven

INTEREST RATE - the relation between the payment received by a lender of money and the amount of money lent, expressed as a percentage per period of time (e.g. at 5% per annum, the lender receives from the borrower $5 for every $100 borrowed)

INTERMEDIARY - a person or organization which acts as an agent in contract negotiations between other persons or organizations

INSTRUMENT - a legal name for a formal document; a document drawn up in legal form (e.g. a bond)

LOAN - a business transaction between two parties whereby one party (the lender) agrees to lend funds to a second party (the borrower); the fee charged for the loan of funds is called interest or discount

MARKET VALUE - the sum of money that could be obtained for an asset if it were sold in the market at a certain time

NOMINAL EXCHANGE RATE - the price of one nation's monetary unit in terms of the monetary unit of another nation

NOMINAL INTEREST - the rate of interest payable on a security, bond, or debt instrument based on its par value

NOMINAL VALUE - same as par value or face value

NONGOVERNMENTAL ORGANIZATION (NGO) - private or non-public entity or organization.

OFFICIAL CREDIT - loans made by international organizations, such as the World Bank (IBRD), the International Monetary Fund (IMF), regional development banks, and other multilateral and intergovernmental agencies; excluded are funds from an international organization on behalf of a single donor government, as these are considered loans from governments

PAR VALUE - (see also face value) the nominal or face value at which stocks, bonds, and debt instruments are originally issued; if the face value of a debt instrument is $100, then $100 is its par value (par price, nominal par); if a debt instrument can be bought for its face value, the price is at par, if it can be bought for a lower sum, its price is below par or at a discount, and if a larger sum has to be paid, its price is above par or at a premium

PARIS CLUB - (synonymous with Group of Ten) under the 1962 General Agreement to Borrow, ten of the principal industrial nations (United States, the Netherlands, United Kingdom, Sweden, France, Japan, Germany, Italy, Belgium, and Canada) along with Switzerland (an unofficial member) make their currencies available to the International Monetary Fund to lend specified amounts when supplementary funds are needed by the IMF

PREMIUM - the amount paid for a stock, bond, or debt instrument that is over and above its face value; "at a premium" refers to the payment of a price higher than the face value of the security

PRINCIPAL - money lent at interest; the amount of the loan made excluding interest payable

PRIVATE CREDIT - includes bonds that are either publicly issued or privately placed; loans from private (commercial) banks and other private financial institutions; credits from manufacturers, exporters and other suppliers of goods; and bank credits covered by a guarantee of an export credit agency

PRIVATE NONGUARANTEED EXTERNAL DEBT - an external obligation of a private debtor that is not guaranteed for repayment by a public entity

PROMISSORY NOTES - a formal, written document containing an unconditional promise, signed by the person making the note, to pay a certain sum of money to, or to the order of, a certain named person, or to the bearer of the document

PUBLICLY GUARANTEED DEBT - an external obligation of a private debtor that is guaranteed for repayment by a public entity

PUBLIC OR OFFICIAL CREDITOR - international organizations (multilateral agencies) such as, the World Bank (IBRD), the International Monetary Fund (IMF), regional development banks, and other multilateral and intergovernmental agencies; governments and governmental agencies

ROUND-TRIPPING - exchanging foreign currency for local currency and then reconverting it into foreign currency, taking the investment out of the debtor country

SECONDARY DEBT MARKET - market in which commercial debt of debtor countries is traded at a discount

SECURITIES - investments generally, and especially stocks, shares, and bonds which are bought as investments

SOFT CURRENCY - currency which has a weak balance of payments and, therefore, a currency for which there is relatively little demand; soft currency can usually be bought cheaply, especially in exchange for hard currency

TRANCHE - a part of a sum of money, such as a loan or payment; an installment

TRANSACTION - the act or process of transacting business affairs

TRANSACTION COSTS - the time and effort required to carry out a transaction; any use of resources required to negotiate and enforce agreements, including the cost of information needed to formulate a bargaining strategy and the time spent haggling and preventing cheating by the parties to the bargain; transaction costs in debt conversion include the time associated with contract negotiation and enforcement, and expenses incurred from intermediary fees, legal fees, brokerage fees and communication fees

TRUST FUND - asset held legally “in trust” by another party

UNDISBURSED DEBT - loan commitments that have not been drawn on during the year specified

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