OPPORTUNITIES FOR LEVERAGING USAID/MALI FUNDS THROUGH DEBT CONVERSION

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I. Summary and Recommendations

This report, prepared by Finance for Development, Inc. ("FFD") for USAID/Mali, identifies potential and existing USAID/Mali projects where debt conversion could serve to leverage USAID's resources. It should be reviewed in conjunction with FFD's "Report on Feasibility of Debt Conversion in Mali", which was also prepared by FFD for USAID/Mali as part of this contract.

In its survey of potential investors in Mali, FFD identified seven development organizations with CFAF project expenditures large enough to undertake debt conversions on their own. Of these potential investors, **Africare**, **Save the Children USA** and **World Education** expressed interest in expanding their existing project activities through debt conversions financed by USAID/Mali. In this regard, debt conversion could be used to leverage funding for project activities in support of USAID's Mali's Governance, Sustainable Economic Growth and Youth strategic objectives.

Other development organizations were interested in considering debt conversion transactions, but prefer to fund debt conversions using unrestricted funding. **The International Union for the Conservation of Nature (IUCN)** is not currently funded by USAID, but IUCN and its partners in the environmental sector would like to obtain USAID support for the creation of a national environmental fund.

As indicated in USAID's Guidelines on Debt for Development, USAID relies on "intermediary organizations" to propose debt conversions financed with USAID funds. Although the initiative for debt conversion transactions has typically come from private voluntary organizations, there are a number of actions that USAID/Mali could take to encourage its development partners to undertake debt conversion transactions. These include:

1. Invite USAID/Mali's partner organizations to propose debt conversions to USAID/Mali;

2. Designate a debt conversion specialist within USAID/Mali's Sustainable Economic Growth strategic objective team;

3. Approve funding requests for preparation of debt conversion proposals and for financing debt conversion transactions in support of USAID-financed projects; and,

4. Consider using debt conversion as a means to leverage funding for new USAID/Mali projects, such as funding for a small grants fund to finance Malian NGOs or community organizations.

II. Survey of Potential Investors in Debt Conversion in Mali

Survey Methodology

The survey upon which this report is based was conducted by Melissa Moye and Michael Smith of FFD during two trips to Mali in November and December 1996. FFD also searched its database for information regarding funding for development organizations operating in Mali, and contacted US-based private voluntary organizations regarding their activities in Mali.

In November 1995, FFD presented two training workshops (in French and English) to familiarize potential investors with the mechanics of debt conversion transactions and the prospects for debt conversion in Mali. Workshop participants included representatives of Malian commercial firms, Malian non-governmental organizations (NGOs), private voluntary organizations (PVOs) and United Nations agencies. FFD consulted with USAID and the U.S. Embassy for recommendations regarding selection of workshop participants to be invited, and, subsequently, many of the workshop participants were interviewed for the survey.

The purpose of FFD's survey was to consult with existing and potential partner organizations of USAID/Mali to: 1) identify potential investors with strong interest in debt conversion transactions; and, 2) identify activities/projects of potential investors that would complement USAID/Mali's strategic plan. Since officials at the Ministry of Finance and Commerce of Mali indicated that the Government of Mali would like to encourage debt-for-development conversions rather than conversions in the for-profit sector, FFD focused primarily on potential not-for-profit investors ("development organizations") with CFAF expenditures large enough to undertake debt conversions on their own.

For each development organization interviewed, FFD sought to determine the organization's interest in debt conversion and its capacity to undertake debt conversion transactions. The following issues were considered in determining whether an organization would be a good candidate to undertake debt conversion transactions in Mali:

Annual CFAF Expenditures: As decribed in the "Report on Feasibility of Debt Conversion in Mali", FFD estimates that it would not be possible for an investor to purchase debt for a purchase price of less than $500,000. Therefore, a development organization would need to have at least this amount available in hard currency funds for conversion into CFAF for project expenditures in Mali.

Sectors: The development organization should have projects in sectors which the Government of Mali has identified as priority sectors for debt conversion in Mali (eg. agriculture/natural resources management, education and health).

Funding Sources: Since many development organizations must seek donor approval for use of donor funds in debt conversion transactions, the sources of the organization's funding may be an important factor in determining their capacity to undertake debt conversion transactions.

Institutional Experience with Debt Conversion: Development organizations which have already undertaken debt conversions in other countries would be more likely to proceed with debt conversions in Mali. Most organizations require headquarters approval before they invest funds in a debt conversion.

Interest in Debt Conversion in Mali: A development organization's interest in debt conversion is primarily based on their desire to fund new or expand on-going project activities. Most organizations will proceed with debt conversion transactions only after they are satisifed that the debt conversion transaction structure adequately protects the organization against delayed or non-payment by the debtor government. Some development organizations are more risk averse than others in evaluating the government performance risk and foreign exchange risk related to payment of debt conversion proceeds.

Results of Survey

The results of selected interviews conducted by FFD are summarized in Appendix A. Most of the development organizations interviewed were USAID-funded PVOs; however, FFD has also provided information regarding IUCN, UNICEF and the *Société pour le Développement des Investissements en Afrique* (SODINAF), because of their strong interest in debt conversion.

FFD identified seven development organizations with CFAF expenditures large enough to undertake debt conversions on their own, as follows: Africare, CARE International, PLAN International, Save the Children USA, UNICEF, World Education and World Vision. FFD also identified a number of organizations with smaller budgets, such as Appropriate Technology International, Freedom from Hunger, IUCN and the Near East Foundation, who may be interested in debt conversion in the event that a debt conversion is funded by a group of PVOs or that additional donor funding is raised for a new project. A French NGO association, *Association Conversion de Dette pour le Développement* (ACDE), also expressed interest in coordinating a debt conversion for its French NGO members, who could have as much as $1 million to $2 million available for investment in a debt conversion.

With regard to sources of funding, some of the organizations interviewed expressed a preference for investing unrestricted rather than donor funds in the event that they decide to proceed with a debt conversion transaction. These organizations were reluctant to take on the administrative burden of requesting donor approval for a debt conversion.

All of the organizations interviewed fund project activities in at least one of the Government of Mali's priority sectors for debt conversion, and were able to identify project activities that they would be interested in funding if additional funds were made available through debt conversion. Most organizations would prefer to use any debt conversion proceeds generated to expand the scope of existing projects. For example, **Africare** has submitted a proposal to the Government of Mali to expand funding for its USAID-funded Goundam Community Health Project and its Niafunke Natural Resources Management Project. A few organizations, such as **IUCN** and **UNICEF** would like to raise donor funding which could be leveraged through debt conversion for new projects.

Almost all of the organizations had at least one experience with debt conversion in another country, although this experience was not necessarily known to the organization's representative in Mali. Since debt conversion was a new concept for most of the representatives interviewed, at this stage, most of them expressed interest in receiving more information before proceeding any further with a debt conversion application. Most of the representatives also indicated that they would need to consult with their head offices.

Many of the organizations would be more likely to proceed with a debt conversion application if the Government of Mali communicated it's interest in debt conversion to the development community. Since all of the organizations lacked confidence in the Government of Mali's ability to perform under a debt conversion agreement, it was felt that the Government needed to demonstrate it's commitment to funding debt conversion transactions. The Government of Mali would need to establish a better payment record before development organizations accepted the Government's performance risk, without a third party guarantee of timely payment.[1]

Some organizations sought clarification regarding the Government's role in monitoring expenditure of the CFAF proceeds generated through debt conversion. Although they accepted that the Government should monitor proper use of debt conversion proceeds to ensure that the funds were spent on approved project expenditures in Mali, they would not be interested in debt conversion transactions if the Government sought to control project implementation.

III. Identification of Opportunities to Leverage USAID Funding Through Debt Conversion

In evaluating the potential development impact of debt conversion in Mali, it is important to consider not only the additional resources that can be generated for development projects in Mali, but also the positive macroeconomic impact of debt reduction. The Government of Mali has made a concerted effort to reduce both external and internal debt through a planned

[1] Different payment mechanisms that could be proposed by development organizations, such as payment into an escrow account or payment in bonds, are discussed in FFD's feasibility report.

debt reduction strategy. With regard to external debt, it has convinced several external creditors to cancel its debt or reschedule the debt on highly concessional terms. In cases where cancellation or further reschedulings are not possible, debt conversion may be a particularly attractive means for the Government of Mali to further reduce its debt burden.

In reducing its debt burden through debt conversion, the Government of Mali expects to be able to reduce its external financing gap and devote more resources to social programs. In financing debt conversion transactions, USAID/Mali can assist Mali to reduce its dependence on concessional foreign assistance, a goal which is at the heart of USAID/Mali's vision statement of "More Mali, Less Aid".

Since PVOs and NGOs are typically the beneficiaries of debt conversions, debt conversions serve to strengthen the role of NGOs, one of the goals of USAID's New Partnerships Initiative. Although local NGOs are unlikely to propose debt conversions on their own because of the small size of their funding, all of the PVOs interviewed by FFD had established partnerships with Malian NGOs who would be likely to benefit from any increase in funding generated through debt conversion.

As expressed in USAID's Guidelines on Debt for Development, which are attached in Annex B, USAID may finance "intermediary organizations"[2] to undertake debt conversions. In addition to the debt reduction objective discussed above, USAID's objective in financing debt conversions is to "obtain a favorable rate of exchange for U.S. foreign assistance dollars that are converted into local currencies or exchanged for other assets needed for foreign assistance programs". Local currency debt conversion proceeds can be used to fund development projects of the type that USAID might typically finance directly.

USAID grantees must submit debt conversion proposals to USAID for approval prior to any debt purchase financed with USAID funds. Both new and on-going projects may be financed through debt conversion. Grantees may also request that USAID fund pre-award technical assistance to enable them to prepare debt conversion proposals. On a case-by-case basis, USAID has permitted grantees to count the proceeds generated by debt conversion towards their matching requirement with USAID.

Requests for authorization to use USAID funds in a debt conversion should provide

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[2] USAID's guidelines indicate that only "intermediary organizations" defined as non-governmental organizations, including cooperatives, private voluntary organizations and universities, can use USAID funds to purchase and convert debt. In practice, USAID has only authorized contractors to carry out debt conversions with USAID funds if the debt conversion proceeds are transferred to a non-governmental organization. The USAID General Counsel's office can provide further guidance regarding the types of organizations that can serve as "intermediary organizations" in debt conversion transactions financed by USAID.

USAID/Mali with complete information regarding the financial terms of the conversion, as well as the project activities to be funded with the conversion proceeds. In cases where a PVO has proposed to finance project activities significantly different from those specified in an original grant agreement, USAID has typically required that the grant agreement be amended to reflect the changed activities.

Since USAID/Mali currently obligates grant funds for periods of up to one year only, USAID/Mali may need to consider obligating additional funds for PVOs who would otherwise be prohibited from undertaking debt conversion transactions. As grant funds are drawn down during the year-long period of obligation, PVOs will have declining funds available to purchase debt. Since creditors typically require payment in one lump sum, PVOs would lack flexibility in effecting debt purchases.

In its survey of potential investors, FFD identified 3 types of debt conversion proposals that could be funded by USAID/Mali, as follows:

1) Debt conversions undertaken by a single USAID grantee;

2) Debt conversions undertaken by more than one USAID grantee; and,

3) Debt conversions to leverage funding for a CFAF fund established to finance development activities for a particular purpose.

1) Debt conversions undertaken by a single USAID grantee

Africare, **Save the Children USA**, and **World Education** expressed interest in leveraging USAID project funding through debt conversion. All of these PVOs receive umbrella grants that finance activities related to USAID/Mali's Youth, Sustainable Economic Growth and Governance strategic objectives. Other USAID-funded PVOs interviewed would prefer to use other sources of funding, preferably unrestricted funding, to undertake debt conversions

Africare submitted a debt conversion application to the Government of Mali which was approved in principle by the Ministry of Finance and Commerce, subject to negotiation of terms for the conversion. Africare also submitted a request to USAID for authorization of use of USAID funds for a debt conversion transaction. Africare has indicated that this request will be revised to reflect the projects to be funded (Goundam and Niafunke) and that further information will be provided to USAID in compliance with the USAID Guidelines.

Save the Children USA would be particularly interested in expanding its project activities in basic education, for example, building more new community schools. **World Education** also expressed interest in expanding its education project, as well as increasing the scope of its urban revitalization and credit projects.

2) Debt conversions undertaken by more than one USAID grantee

USAID/Mali may wish to consider funding debt conversions that benefit more than one implementing organization for projects in a particular sector. For example, in 1994, a debt-for-development conversion was completed for PROCOSI, an umbrella organization in Bolivia comprised of several leading PVOs, including CARE, Catholic Relief Services and Save the Children USA. Twenty Bolivian organizations involved in child health services also benefited from the conversion. Using $5 million in funding provided by USAID, PROCOSI received $7.5 million in Bolivian currency to fund activities in child survival.

Although it is much easier for a single organization to undertake a debt conversion, it may be possible for more organizations to participate in a debt conversion in the event that a group of PVOs/NGOs joins together for purposes of the conversion. As described in "The Program Assessment of USAID/Mali's PVO and NGO Activities"[3], there is no real incentive for PVOs in Mali to collaborate, except due to the procedural demands of a specific donor agency. Because it is advantageous to negotiate the purchase of a large amount of debt, it may be in the interest of PVOs to collaborate in order to faciliate a debt purchase, but they may be less interested in participating in a debt conversion that entails working together on project implementation.

Save the Children USA expressed interest in seeking PVO partners to facilitate a debt conversion in the education sector. A partnership could also involve a coordinating role for the PIVOT group for Basic Education.

Because of the size of Africare's CFAF expenditures, **Africare** may need to consider purchasing debt at the same time as another organization in order to facilitate its debt purchase.

3) Debt conversions to leverage funding for a CFAF fund established to finance development activities for a particular purpose

As discussed in FFD's feasibility report, debt conversion can be used as a means of leveraging hard currency funds for the creation of a local currency fund established to finance development activities. FFD believes that a sinking fund or a revolving fund would be the most appropriate type of fund in light of the lack of local investment vehicles in Mali.

USAID/Mali's Governance strategic objective team may wish to consider the possibility of leveraging USAID funds through debt conversion in the event that a small grants fund is

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[3] "Program Assessment of USAID/Mali's PVO and NGO Activities: Prospects for Enhanced Collaboration and Success", by Curt D. Grimm, Lillian Baer, Yacouba Konate and Tiemoko Diallo, April 1995.

established to finance Malian NGOs or community organizations[4]. Debt conversion could also be considered as a means of generating additional funding for work with local community groups involved in natural resources management activities.

In November 1995, **IUCN**, in cooperation with the Ministry of Rural Development and the Environment, sponsored a workshop on debt conversion that led to the establishment of an ad-hoc committee to consider the establishment of a national environmental fund. **UNDP** participates in this initiative, which is of interest to **UNSO (Office to Combat Desertification and Drought)**. The United Nations Convention to Combat Desertification, adopted in June 1994, provides for the establishment of national desertification funds. IUCN has approached USAID and other donors regarding possible financing of an environmental fund.

V. Conclusion

In light of the decline in funding for foreign assistance activities, debt conversion offers an opportuntity for USAID and other donors to stretch their development dollars, while helping Mali to reduce it's external debt. Since most PVOs/NGOs are characteriscally risk averse, donor support for debt conversion transactions can help convince the development community that debt conversion transactions can be structured so that they are beneficial for all the parties involved. In reviewing debt conversion proposals, USAID/Mali should use existing criteria and objectives to evaluate the merits of each project activity. The financial terms of the debt conversion should be structured to match the funding cycle of the project activity. In this way, debt conversion can be used to benefit projects in support of USAID/Mali's strategic objectives.

[4] "Key Factors in Establishing Foundations and Endowments in Mali", November, 1993, Kunafoni Services, considers the idea of establishing a **community development foundation**.

VI. Appendices

A. Debt Conversion Survey

Africare
CARE International in Mali
International Union for the Conservation of Nature (IUCN)
PLAN International
Save the Children USA
SODINAF, S.A.
UNICEF
World Education
World Vision

B. USAID Guidelines on Debt for Development, April 11, 1990

Appendix A

Debt Conversion Survey

Name of Organization:	Africare
Representative(s):	McKinley Posely Country Representative
Annual CFAF Expenditures: (US$ Equivalent)	about $500,000
Sectors:	child survival community health natural resource management
Funding Sources:	USAID private and foundation donations
Institutional Experience With Debt Conversion:	Zambia, Zimbabwe
Interest in Debt Conversion in Mali:	Strong interest. Submitted debt conversion application to the Ministry of Finance and Commerce to expand funding for Africare's Goundam Community Health Project and Niafunke Natural Resources Management Project. Both projects are funded by USAID/Mali and Africare would need to receive USAID/Mali authorization before proceeding with a debt purchase. Because of the size of it's annual budget, Africare may need to purchase debt in conjunction with another development organization in Mali.

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Name of Organization:	CARE International
Representative(s):	Dawn Wadlow Assistant Director for Operations
Annual CFAF Expenditures: (US$ Equivalent)	about $3 million
Sectors:	agriculture AIDS prevention education family planning health microenterprise natural resources management
Funding Sources:	private donations USAID NORAD (Norway) Government of the Netherlands ODA (United Kingdom)
Institutional Experience With Debt Conversion:	Bolivia, Zambia
Interest in Debt Conversion in Mali:	CARE International would prefer to see a successful precedent for a debt-for-development conversion by another PVO in Mali before considering their own application. Debt conversion proceeds could potentially be used to expand funding for CARE International's project activities in agriculture, AIDS, literacy, microcredit and infrastructure rehabilitation in the north of Mali.

Name of Organization:	International Union for the Conservation of Nature (IUCN)
Representative(s):	Seydou Bouare, Chef de la Mission Alain Lambert, Development Officer (Headquarters)
Annual CFAF Expenditures: (US$ Equivalent)	SF 262,000
Sectors:	Environment
Funding Sources:	Multiple Donors
Institutional Experience With Debt Conversion:	Guinea-Bissau, Zambia. Actively seeking conversion opportunities in other countries.
Interest in Debt Conversion in Mali:	Strong interest. Sponsored November 1995 workshop on debt conversion in cooperation with the Ministry of Rural Development and the Environment. Coordinate ad-hoc committee to consider the establishment of a national environmental fund.

Name of Organization:	Plan International
Representative(s):	Terrence McCaughan, Country Director Duncan Campbell
Annual CFAF Expenditures: (US$ Equivalent)	about $5.5 million
Sectors:	agriculture AIDS prevention credit education health roads
Funding Sources:	mostly child sponsorship private donations USAID/Mali CIDA
Institutional Experience With Debt Conversion:	Phillipines
Interest in Debt Conversion in Mali:	Strong interest. Interested in possibility of expanded funding for AIDS prevention and education projects.

Name of Organization:	SODINAF S.A.
Representative(s):	Aliou Boubacar Diallo, President
Annual CFAF Expenditures: (US$ Equivalent)	not known
Sectors:	gold mining
Funding Sources:	own funding represents international gold mining companies
Institutional Experience With Debt Conversion:	Completed debt-for-equity conversion in 1993 for investment in the gold mining sector.
Interest in Debt Conversion in Mali:	Strong interest. Submitted debt conversion application to the Ministry of Finance and Commerce on behalf of two gold mining companies for conversion of debt owed by Mali to ECGD, the United Kingdom's export credit agency.

Name of Organization:	Save the Children USA
Representative(s):	Peter Laugharn, Director
Annual CFAF Expenditures: (US$ Equivalent)	about $3 million
Sectors:	health education micro-enterprise natural resources management
Funding Sources:	mostly USAID private donations
Institutional Experience With Debt Conversion:	Bolivia
Interest in Debt Conversion in Mali:	Interested. Hope to explore possible collaboration with other organizations, particularly in the education sector. Proceeds of debt conversion could be used for teacher training, school building, expanded access to schools and community mobilization.

Name of Organization:	UNICEF
Representative(s):	Andre Roberfroid, Representative
Annual CFAF Expenditures: (US$ Equivalent)	not known
Sectors:	health and education
Funding Sources:	multiple donors
Institutional Experience With Debt Conversion:	Extensive. Coordinated by Program Funding Office in New York headquarters. Conversions in Bolivia Jamaica, Madagascar, Peru, the Phillipines, Senegal Sudan and Zambia.
Interest in Debt Conversion in Mali:	Submitted debt conversion application to Ministry of Finance and Commerce. UNICEF/Mali is seeking funding from UNICEF National Committees for debt conversion for teacher training project.

Name of Organization:	World Education
Representative(s):	Nancy Devine, Director
Annual CFAF Expenditures: (US$ Equivalent)	$2-3 million
Sectors:	urban revitalization community school development credit
Funding Sources:	USAID
Institutional Experience With Debt Conversion:	none
Interest in Debt Conversion in Mali:	Interested in possibility of expanding current programs through debt conversion. Concerned about government performance risk.

Name of Organization:	World Vision
Representative(s):	Torrey Olsen, Program Director
Annual CFAF Expenditures: (US$ Equivalent)	about $4 million
Sectors:	multi-sectoral
Funding Sources:	private donations USAID
Institutional Experience With Debt Conversion:	Tanzania, Zambia
Interest in Debt Conversion in Mali:	Strong interest. Need more information, contact with headquarters offices.

Appendix B

USAID Guidelines on Debt for Development, April 11, 1990

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AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

April 11, 1990

A.I.D. ANNOUNCES DEBT FOR DEVELOPMENT INITIATIVE

In response to the debt crisis facing many developing countries, the U.S. Agency for International Development (A.I.D.) is initiating a new Debt for Development mechanism to finance development assistance activities of non-governmental organizations. Through this new Initiative, A.I.D. will support certain programs of non-governmental organizations in developing countries through debt exchange transactions that will both reduce the host countries' debt burdens and obtain a favorable rate of exchange for foreign assistance funds provided to such organizations.

I. INTRODUCTION TO THE A.I.D. INITIATIVE

A. Summary

With the Debt for Development Initiative, A.I.D. will use foreign assistance funds to finance the purchase, by intermediary organizations, of debt currently owed by developing countries to foreign creditors. A.I.D. will finance the purchase of debt at the discount price at which such debt is currently bought and sold on the secondary market.

Instead of seeking to collect the full face value of debt acquired through the Debt for Development Initiative, however, A.I.D. will provide for the retirement of the debt in exchange for resources that the debtor country will provide for use in development activities. For example, debt acquired with A.I.D. funds could be retired in exchange for local currencies to be used in A.I.D.-financed health and nutrition programs in the debtor country. By converting foreign assistance dollars into local development resources (such as local currencies) through the debt exchange market, A.I.D. will be able to reduce the debt burden of developing countries while also obtaining local development resources at a favorable rate of exchange.

Resources received through Debt for Development transactions will be used for A.I.D.-financed projects of non-governmental organizations, such as private voluntary organizations (PVOs), cooperatives, and universities that are not instruments of the aid recipient country's government. These organizations will play a central role in the Debt for Development Initiative by serving as intermediaries between A.I.D. and the current owners ("holders") of developing country debt, as well as between A.I.D. and the debtor countries, for the purpose of acquiring and retiring debt. Intermediary organizations will then be responsible for managing the use of resources acquired through the debt exchange for development activities approved by A.I.D.

B. Background on the International Debt Market

Many developing countries face serious difficulties in repaying high volumes of debt owed to foreign governments and private commercial lenders. Payments of principal and interest on debt consume a large proportion of the foreign currencies earned by developing countries. Heavy debt burdens also limit opportunities for obtaining new credit, thus impeding development efforts.

In recent years a private commercial market has developed for the debt obligations of nations ("sovereign debt"), which can be bought or sold like other commercial property. Because of the increasing risk that many heavily indebted countries will be unable to repay either all or part of their debt, debtholders have become willing to sell the debt or an amount less than the debt's face value. Debtholders may wish to sell this debt, even at a "loss" resulting from the discount price, in order to capture the debt's current value and to reduce the volume of non-performing loans in their loan portfolios.

Parties wishing to invest, conduct other forms of business, or support development activities in developing countries may find it attractive to purchase the debt of developing countries at current discount prices. After buying the debt, the new debtholders exchange or swap the debt for assets (such as local currencies or equity shares in local enterprises) provided by the debtor country. The value of the assets received in this exchange may be less than the debt's face value but greater than the debt's purchase price. Thus the buyer ultimately gains a more valuable asset in the debtor country through the mechanism of the debt exchange than through direct acquisition with dollars or use of conventional currency exchange markets.

Developing countries also benefit from debt exchange transactions, because these countries retire a certain amount of foreign debt while gaining new participants in their economies (for example, new investors in private enterprises). Debtor nations generally cannot take advantage of the discount sale price of their debt by purchasing their own loans directly, because the terms of most loan agreements bar such purchase. Therefore, most debt exchange transactions require purchase of the loan asset by a third party serving as intermediary between the lender and the borrowing country.

C. Participation by A.I.D. in the Debt Exchange Market

The new international debt market presents A.I.D. with an opportunity to achieve several objectives, consistent with the purposes of the U.S. foreign assistance program. Through the new Debt for Development Initiative, A.I.D. will participate in this market by using foreign assistance funds to finance the purchase of loans owed by developing countries to foreign creditors. Instead of collecting such loans, A.I.D. will provide for their retirement in exchange for local assets needed for foreign assistance activities of non-governmental organizations in debtor countries.

A.I.D. will finance all debt exchange transactions through intermediary organizations, such as private voluntary agencies and cooperatives. A.I.D. will issue grants to intermediary organizations to purchase debt. Intermediaries will subsequently convert this debt into local assets, which the intermediaries will use for either newly initiated or ongoing development projects approved by A.I.D. Participation by intermediaries in Debt for Development will strengthen the development programs of these organizations while simultaneously advancing the other stated objectives of the Debt for Development Initiative.

A.I.D. will finance debt exchange transactions yielding various types of host country assets needed for development activities. For example, debt could be exchanged directly for local currencies needed to finance development activities, such as education and health programs, in the debtor country. Intermediaries could also exchange A.I.D.-financed debt for host country programs, such as commitments to conserve natural resources or protect endangered species ("debt for nature"), in a manner similar to the recent debt exchange agreement between the Government of Bolivia and a private organization (Conservation International) to protect tropical rain forest in Bolivia. A wide range of A.I.D.-financed programs of non-governmental organizations will be eligible for financing with resources obtained through the Debt for Development Initiative.

Each activity of a non-governmental organization financed through a Debt for Development transaction must be approved by A.I.D. in accordance with standard Agency rules and procedures applicable to funding of non-governmental organization activities. Both new and ongoing activities of non-governmental organizations will be eligible for financing, either in whole or in part, through A.I.D. Debt for Development transactions.

D. Illustrative Transaction

Each Debt for Development transaction will be accomplished through a series of agreements and transactions involving the debtor country, the debtholder, A.I.D., and an intermediary organization. The A.I.D. Debt for Development Guidelines, which follow in Part II, will govern these transactions. The following hypothetical transaction shows in abbreviated form the steps needed to complete a typical Debt for Development exchange.

Example: A private voluntary organization dedicated to preservation of endangered species (in this hypothetical example, the organization will be called "Preservation International") has received a commitment by A.I.D., or is preparing to submit a proposal to A.I.D., to fund a project to preserve a species of wildfowl in the Philippines. This project will require a sum of local currencies to finance a wildfowl protection plan, as well as a commitment by the Government of the Philippines to set aside a significant acreage of public land as a wildfowl refuge.

Preservation International determines that the Government of the Philippines owes a substantial quantity of debt to foreign creditors (such as banks), and that certain creditors are selling their Philippine Government debt at a substantial discount. Preservation International contacts A.I.D./Washington or the A.I.D. Mission in Manila to determine whether the acquisition of Philippine Government debt as part of a debt exchange to finance a wildfowl preservation project in the Philippines would be consistent with U.S. and multilateral economic policy and A.I.D. project priorities in the Philippines.

If A.I.D. responds favorably to Preservation International's enquiry, representatives of the organization (perhaps in collaboration with USAID Mission personnel) initiate a discussion with representatives of the Government of the Philippines, most likely including representatives of the Central Bank. These discussions explore the interest of the Philippine Government in supporting a wildfowl preservation project financed through the proceeds of a Debt for Development transaction financed by A.I.D. Preservation International reaches an agreement in principle with the Government on the basic terms of a Debt for Development agreement establishing the terms, mechanism, and schedule for retirement of Philippine Government debt in exchange for local currency and Government commitments to establish a wildfowl refuge. Preservation International also confirms the availability of Philippine debt for sale on the secondary commercial market and the current price of such debt.

Preservation International then prepares a proposal for A.I.D. describing, among other things, the wildlife preservation objective of the project, the anticipated role of Philippine debt

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in financing the project, the availability of such debt for purchase, the proposed use of a broker or other means to acquire and process the debt certificates, the willingness of the Government of the Philippines to provide local currency and wildfowl refuge commitments in exchange for retirement of debt, and a plan for use of local currency to meet project objectives.

If A.I.D. agrees to finance the project, it enters into an agreement with Preservation International setting forth the basic terms and procedures of the Debt for Development transaction, as well as other issues normally addressed in a project agreement. With the financing for the transaction assured, Preservation International enters into a formal agreement with the Government of the Philippines setting the terms for the eventual debt exchange.

Preservation International then negotiates a favorable discount price for purchase of a volume of Philippine Government debt from a willing commercial seller. Consistent with the Debt for Development agreement between A.I.D. and Preservation International, A.I.D. provides grant funds to finance the purchase of this debt. Preservation International takes title to the debt but promptly retires it in exchange for the local currency and commitments promised by the Government of the Philippines in the Government's separate agreement with Preservation International.

Preservation International subsequently utilizes the local currency, which the Government provided in exchange for the debt retirement, for wildfowl preservation purposes. It monitors the Philippine Government's compliance with its commitment to set aside a wildfowl refuge, as provided in the debt retirement agreement, and it administers the project in a manner otherwise consistent with standard rules governing A.I.D.-financed projects.

II. A.I.D. DEBT FOR DEVELOPMENT GUIDELINES

A.I.D. has prepared the following Debt for Development Guidelines to govern administration of the Agency's Debt for Development Initiative. These Guidelines describe the role of intermediary organizations in the Initiative, the types of A.I.D. grants that will be available, and the various administrative and contractual procedures required in order to effect a Debt for Development transaction. A.I.D. expects to modify these Guidelines as it gains experience with the Debt for Development Initiative.

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A. Introduction

1. Scope and Applicability: The following Debt for Development Guidelines govern the programming of funds made available to the Agency for International Development (A.I.D.) under the Economic Support Fund (ESF) and Development Assistance (DA) accounts (including the Development Fund for Africa), to the extent such funds are used to finance the purchase of debt owed by developing countries to parties other than the United States Government. All such debt acquired with A.I.D. financing will be exchanged for local currencies or other assets (such as local currencies or host country development efforts) needed to achieve one or more objectives of the ESF or DA program.

Organizations receiving foreign assistance funds from A.I.D. may not use such funds to acquire debt owed by developing countries, or engage in other transactions involving such debt, without prior approval of A.I.D. All debt acquisitions financed directly or indirectly by A.I.D. shall be undertaken in accordance with these Debt for Development Guidelines.

2. Purpose of Guidelines: These Guidelines are designed to ensure that A.I.D.-financed Debt for Development programs achieve the objectives stated in these Guidelines and operate in a manner consistent with United States laws governing the use of appropriated funds.

3. Issuing Party and Authority: A.I.D. issues these guidelines under the authority provided in the Foreign Assistance Act of 1961, as amended.

4. Modifications to Guidelines: Modifications to these Guidelines may be needed as A.I.D. gains experience with its Debt for Development program. Parties cooperating with A.I.D. in the implementation of this Initiative are encouraged to identify problems that arise in applying these Guidelines and to suggest any needed changes.

B. Objective

The objective of the A.I.D. Debt for Development Initiative is to finance foreign assistance activities of non-governmental organizations (such as voluntary agencies and cooperatives) through debt transactions that will:

-- (1) assist in reducing the foreign debt burdens of developing countries that receive U.S. foreign assistance, consistent with the general economic development purposes of the U.S. foreign assistance program; and

-- (2) obtain a favorable rate of exchange for U.S.

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foreign assistance dollars that are converted into local currencies or exchanged for other assets needed for foreign assistance programs.

C. General Statement of Policy

To achieve the objectives stated above and consistent with A.I.D. rules and regulations (including the present Guidelines), A.I.D. invites non-governmental organizations (referred to in these Guidelines as Debt for Development "intermediary organizations" or "intermediaries"), such as private voluntary organizations (PVOs), cooperatives, and universities which are not instruments of the aid-recipient country's government, to develop proposals for grants and cooperative agreements with A.I.D. to implement the A.I.D. Debt for Development Initiative.

A.I.D. will review proposals by intermediary organizations to use foreign assistance funds to finance the purchase, by the intermediary organization, of debt owed by developing countries to parties other than the United States Government. Such proposals must provide for prompt retirement of such debt through an exchange of the debt for local currencies or other assets furnished by the debtor country to the intermediary for development activities. A.I.D. will receive Debt for Development proposals from intermediary organizations in a wide range of program areas, such as environmental protection, population planning and health, and microenterprise development for both new and ongoing project activities.

A.I.D. will issue a limited number of awards to assist intermediary organizations to develop proposals for Debt for Development transactions that will achieve foreign assistance purposes. Once a Debt for Development transaction has been approved, A.I.D. will closely monitor the intermediary's use of A.I.D. funds to acquire debt and, in appropriate circumstances, will provide technical advice (usually through consultants) to assist intermediaries in purchasing and exchanging debt.

D. Debt for Development Procedures

1. Role of Intermediary Organizations: A.I.D. will not directly acquire debt of a developing country for use in a Debt for Development exchange. Instead, A.I.D. will provide foreign assistance grant funds to finance the acquisition of such debt by intermediary organizations. In consultation with A.I.D. Missions, intermediaries will negotiate with the debtor country the terms of the subsequent debt retirement. Intermediaries will also arrange for the purchase of debt and will assume primary responsibility for managing the use of assets generated by the

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debt retirement. Intermediary organizations, therefore, will play a central and critical role in the A.I.D. Debt for Development Initiative.

2. <u>Types of A.I.D. Awards</u>: To assist the participation of intermediary organizations in Debt for Development transactions, A.I.D. intends to make foreign assistance funds available to support both (a) the preparation of Debt for Development proposals by intermediaries, and (b) the acquisition and retirement of the debt itself once an intermediary's proposal for a Debt for Development program has been approved by A.I.D. A.I.D. expects to allocate a larger share of foreign assistance resources to acquire the debt than to assist preparation of Debt for Development proposals.

a. <u>Awards to support preparation of proposals</u>: As described more fully in Part II(D)(5) of these Guidelines, A.I.D. will agree to finance debt transactions only after an intermediary organization and a debtor country have reached an agreement in principle on the purpose and terms of the eventual debt exchange, and after the intermediary has investigated the availability and price of a particular country's debt on the international commercial market. Extensive negotiations between the intermediary and debtor nation, as well as various studies and consultations regarding the availability of a country's debt for purchase, may be needed to meet these preconditions.

A.I.D. will expect most non-governmental organizations to furnish the staff and resources needed to meet the above preconditions. However, A.I.D. will issue a limited number of awards to assist intermediary organizations in preparing Debt for Development proposals and in negotiating the terms of the debt exchange with the debtor nation. Such awards will be made only to those intermediary organizations that can demonstrate a capacity to undertake successfully the complex tasks of a debt exchange transaction, as well as to administer the development activity to be financed by the transaction.

Applications for financing to support pre-award Debt for Development activities should address the following issues: (1) the nature of the development activity or ongoing project to be financed with assets acquired through the Debt for Development transaction; (2) the information needed and steps proposed to be undertaken to develop a final proposal and to reach agreement with the debtor country on the use of assets generated through the debt transaction; (3) the opportunities for purchase and the current market price (to the extent such information is readily available) of the country debt to be acquired with A.I.D. financing; (4) the anticipated advantages of acquiring local development assets by means of debt exchange rather than through direct purchase with dollars; and (5) the projected allocation of costs and expenditure of time needed to develop a final proposal.

b. Awards to finance Debt for Development transactions: A.I.D. will also make resources available to finance Debt for Development transactions by intermediaries. The following provisions of these Guidelines set prerequisites for the award of funds by A.I.D. to finance Debt for Development transactions and establish procedures for effecting such transactions once an intermediary's proposal for a debt exchange has been approved.

3. Foreign Assistance Purpose of Each Debt Transaction: All Debt for Development transactions will advance the fundamental foreign assistance purpose of reducing a country's foreign debt burdens (see "Objectives" specified in Part II(B)). For A.I.D. to approve a Debt for Development proposal, however, the assets acquired through a Debt for Development transaction must be used for a specific development assistance activity of a non-governmental organization. The purpose of this activity must be consistent with the objectives of the particular category of assistance from which A.I.D. makes the Debt for Development award, and it must be clearly defined in advance of the issuance of that award.

For example, Development Assistance funds made available from the Agriculture, Rural Development, and Nutrition (Foreign Assistance Act ("FAA") Section 103) account will be used only to acquire debt that is to be converted into assets needed to advance Section 103 purposes. Development Assistance funds made available from the Population and Health (FAA Section 104) account will be used only to acquire debt that is to be converted into assets needed to advance population planning and health activities. Similarly, resources from the Development Fund for Africa will be used only to acquire debt to be converted into assets needed to advance development programs in sub-Saharan Africa. Economic Support Funds, to the extent available for Debt for Development transactions, may be used more broadly to advance ESF objectives of economic or political stability. In reviewing an application for a Debt for Development transaction, A.I.D. will consider whether the ultimate use of the asset generated through the transaction is defined with sufficient specificity and is within the purposes of an available funding source.

4. Purchase of Debt at Lowest Possible Prices from Established and Reputable Sellers; Requirement of A.I.D. Approval: A.I.D. financing may only be used to purchase debt from established and reputable debtholders, such as major commercial banks. A.I.D. will expect each intermediary to use A.I.D. financing to acquire debt from such sellers at the lowest

possible price, reflecting the full discount value of such debt in private commercial markets. No intermediary may use A.I.D. financing to acquire debt without A.I.D.'s express prior approval of the proposed transaction and sale price.

5. Pre-Agreement on Purpose and Terms of Debt Purchase and Retirement: Debt for Development transactions will be used to finance intermediary organization projects approved according to the usual A.I.D. standards and rules governing projects.

In addition to standard requirements, however, before A.I.D. agrees to finance a Debt for Development transaction, the intermediary must demonstrate to the satisfaction of A.I.D. that the intermediary has: (a) identified the asset to be obtained and the program activity to be financed through the debt transaction; (b) reached at least an agreement in principle with the debtor country regarding the terms, mechanism, and schedule for conversion of the debt into the identified host country asset; and (c) developed a budget and plan for use of the host country asset to achieve project purposes. An intermediary's mere expression of intent to use assets generated from a debt exchange for a general foreign assistance purpose will not be sufficiently definite to enable A.I.D. to make a financing award; before issuing an award, A.I.D. will require careful program planning and evidence of the debtor country's prior concurrence (for example, in the form of a signed agreement or a letter from the country's central bank or ministry of finance) on significant aspects of the eventual debt exchange.

A.I.D. will also require the intermediary to demonstrate that it has: (a) investigated the availability of the host country's debt for sale, (b) identified a reputable and willing seller of such debt (as discussed in Part II(D)(4) above), (c) determined the likely market price of the debt, (d) calculated the likely transaction costs to be incurred in acquiring and exchanging such debt, and (e) analyzed the financial and other advantages of acquiring the local development assets through the mechanism of a debt exchange rather than by direct purchase with dollars. To develop a Debt for Development proposal that addresses each of the above points and that is sufficiently specific and definite, an intermediary may, if needed, request pre-agreement funding from A.I.D. (as described in Part II(D)(2)(a) above). A.I.D., however, expects to make available only a limited amount of funding for this purpose.

6. Various Agreements Required: To effect the various transactions involved in a Debt for Development plan, separate agreements among parties will be required, in the following sequence: (a) between A.I.D. and the intermediary approving the terms and conditions of the foreign assistance

financing; (b) between the intermediary and the debtor country establishing the purpose and terms (as described in Part II(D)(5) above) of the planned debt exchange; and (c) between the intermediary and the debt holder effecting the initial sale of debt.

In exceptional cases it may be most efficient to combine the first two of these agreements into a single multi-party agreement among A.I.D., the intermediary and debtor country. A.I.D. will not be a party to the agreement between the seller of the debt and the intermediary organization. As discussed in Part II(D)(4) above, however, A.I.D. will require the intermediary to receive A.I.D.'s express approval of the proposed transaction and sale price before the intermediary expends A.I.D. funds to acquire debt.

7. Technical Assistance and Fees Incurred in Purchasing Debt: To assist intermediaries to purchase debt in the new international debt market, A.I.D. may make available to such intermediaries the services of financial consultants. A.I.D. funds may also be used to pay reasonable fees and transaction costs incurred by an intermediary in the purchase and exchange of debt, if such use of A.I.D financing is included in the Debt for Development agreement between A.I.D. and the intermediary.

8. Prompt Conversion of Debt into Development Asset: A.I.D. expects intermediaries to convert A.I.D.-financed debt into local currency or other development asset (as provided in the various Debt for Development agreements among the intermediary, debtor country and A.I.D.) as promptly as possible after the intermediary acquires the debt. Intermediaries may not: (a) retain title to such debt for speculative or other purposes, or (b) exchange the debt of one country for the debt of another country without prior approval of A.I.D.

9. Use of Development Asset by Intermediary: The intermediary shall promptly report to A.I.D. the nature and amount of the development asset acquired through an A.I.D.-financed Debt for Development transaction. On a quarterly basis the intermediary shall also report to A.I.D. on the use of the asset for the agreed upon development purpose, and it shall comply with any further reporting requirements included in project agreements with A.I.D. The intermediary shall promptly transfer to A.I.D. any asset that for any reason the intermediary has become unable to use in a manner consistent with its Debt for Development agreement with A.I.D.

10. Interest Earned on Local Currencies Obtained from the Debt Exchange: Subject to agreement by A.I.D. and any special rules to be issued by A.I.D., the intermediary may earn

and retain interest or other forms of income on the principal amount of local currencies obtained by the intermediary through debt exchange transactions, and the intermediary may use such principal and income either directly for approved program purposes or to establish an endowment for long-term financing of such program purposes. During the life of the project, the intermediary shall make quarterly reports to A.I.D. of the amount of such local currencies earned, retained or used for project purposes.

11. Installment Payments in Exchange for Debt Retirement: The agreement between a Debt for Development intermediary and the debtor country may provide for the debtor country, in exchange for retirement of the A.I.D.-financed debt, to furnish the development asset (such as local currencies) to the intermediary in installments rather than in a single lump-sum.

Installment payment amounts may take into account variations in the rate of exchange of units of local currency for dollars occurring during the payment term. For example, in exchange for retirement of the debt, the intermediary could receive a dollar-denominated note providing for installment obligations equal in value to a fixed sum of dollars, with installment payments to be made in local currencies in an amount calculated according to the exchange rate from dollars to local currencies applicable at the time of each payment.

In reviewing a proposal for such installment payments in exchange for debt retirement, A.I.D. and the intermediary should consider the risk of non-payment by the debtor country and whether insurance or other guarantees against non-payment should be provided to reduce the risk of loss.

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