ALSF SOVEREIGN DEBT KNOWLEDGE PRODUCT AND CAPACITY BUILDING PROJECT: KEY CONSIDERATIONS FOR INCURRING NON-TRADITIONAL DEBT GUIDE

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Acronyms	Meaning Relevant
CPI	Consumer Price Index
DSRA	Debt service reserve account
GMTN	Global Medium Term Note Programme
HIPC	Highly Indebted Poor Country
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IMF	International Monetary Fund
KRG	Kurdistan Regional Government
LED-CR Sovereign	Less economically developed sovereign
LMA	Loan Market Association
LSTA	Loan Syndications and Trading Association
MVP	Majority voting clause
PCS	Preferred creditor status
PXF	Pre-export finance
SOE	State Owned Enterprise
SPE	Special purpose entity
SPV	Special purpose vehicle

Executive Summary

ALSF sovereign debt knowledge product and Capacity Building Project:

Debt guide on key considerations for incurring non-traditional debt

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For the African Legal Support Facility

This guide is addressed the civil administration officials who are responsible for their country's debt management. The general mandate of these officials is likely to include why their country needs to raise debt, where and how the amounts borrowed need to be spent, (c) how this contributes to economic welfare, what matters for the country's overall debt sustainability and how to manage the cash-flows of the debt. Most of these officials are likely to be economists and finance experts, whose main focus will be on the cash-flow provisions of the debt raised by the country. This is even more likely to be the case for debt raised by established and commonly used debt instruments – what we call "traditional debt".

What of the non-cash flow provisions of the debt instruments, even the commonly used ones? What of any provisions in less commonly used debt instruments – non-traditional debt? What of the interaction of "traditional" and "non-traditional" debt or even of the interaction between two "traditional" forms of debt? What should officials care about? And how can these considerations help the overall debt management process?

The first chapter of this guide - Key Considerations for Incurring Non-Traditional Debt – tries to answer these questions. It does this by identifying two features which make sovereign debtors radically different from any other debtor. The first is that sovereign debt is a public good, whereas for all private entities debt is a private facility to enable the generation of profits for the owners. The second is that a sovereign is a special type of debtor. Debt crises and insolvency for sovereigns mean something very different than for private entities. The first feature dictates the purpose of the debt, its contribution to the public welfare and economic growth, and, more broadly, its public nature. The second feature sets the perimeters within which public debt can be re-set and restructured. The guide considers these two features in more depth.

Corporate debt has a very narrow goal: to increase corporate profits and maximize returns to those in the capital structure who hold the equity. Sovereign debt by contrast does not have a separate "equity" in its capital structure. Its "equity-holders" are the sovereign itself, its citizens, its enterprises and their common welfare: defence, infrastructure (transportation, schools, hospitals, utilities etc.), social programmes, public emergencies (natural disasters, pandemics etc). The ability of the sovereign to raise debt, and its credibility to sustain it, affects the ability of others to raise debt – sub-nationals, SOEs, utilities, banks, but also all enterprises more broadly. The quality of the sovereign's debt is the basis of financial reliability for domestic economic growth and hence the welfare and prospects of its enterprises and citizens. Officials must therefore manage sovereign debt for the benefit of the public, as part of overall good governance. "Public benefit" is determined by the dynamics of the sovereign's domestic political economy. These dynamics, by their nature, evolve over time.

For sovereigns therefore (a) "cost of capital", (b) the proper way of (i) accounting for the sovereign assets, and (ii) determining the sovereign debt sustainability, are far more complex matters than for corporates.

This gives rise to the first principle which officials should bear in mind when considering any type of debt "How to account for a [non-traditional] debt instrument, how to incorporate it in the cash-flow and the debt sustainability models and how

to approach its non-financial provisions". The principle is twofold. It is first and foremost a quantitative principle underscoring the importance of proper recording and accounting of cash-flows, returns, and contingencies. It is also a qualitative principle focusing on the non-financial terms which may prove to be onerous or constraining.

Sovereigns are special debtors. Enterprises are subject to the laws of the sovereign, whereas sovereigns are the creators of

[domestic] law and so, in a sense, "above the law". Sovereigns cannot be legally coerced. Sovereigns enjoy "state sovereignty" and "sovereign immunity". As a result, there are no hard legal constraints on a sovereign – except the ones the sovereign expressly accepts. A sovereign can accept legal constraints on its debt such as an external system of law and can waive its sovereign immunity. Nonetheless, these constraints are limited, and the sovereign is still free of external legally mandatory compulsion, as opposed to compulsion because of an overall cost benefit analysis of the sovereign's interests and constraints. It is the sovereign that chooses what constraints it will accept. At an extreme a sovereign can decide whom to pay and whom not to pay – for the sovereign this is just a matter of overall cost/benefit analysis.

Sovereigns overall choose to honour their commitments and not act whimsically. They choose to respect the rule of law. When they cannot meet all their financial obligations, they overwhelmingly choose to follow a fair process. They do act under any external legally mandatory compulsion. They make these choices because, in their cost/benefit calculus, almost all sovereigns place a high value to the honouring of their commitments, to a fair process and more broadly to the rule of law, as these enhance their continuous credibility and allow them to develop economically and prosper in the community of nations.

The special nature of a sovereign debtor becomes clearer when it loses market access. Unlike creditors to corporates, creditors to sovereigns (a) can at best obtain a judgment against the sovereign but (b) will never be able to enforce against the domestic assets of a sovereign debtor. At the most a creditor will be able (i) to assert its claim subject only to the contractual terms and (ii) to seize assets outside the sovereign's jurisdiction, subject to the immunity rules where these assets are situated.

At the same time a sovereign debtor can never write down its debt unilaterally. This can will remain unresolved without any finality, unless the sovereign and its creditors agree on a solution. A solution will always be possible if both the sovereign and the creditors believe that (a) following the debt restructuring, the sovereign will be able to return to prosperity, and (b) their relationship is long-term and symbiotic, i.e., the sooner the sovereign's economy returns to growth, the fewer the overall deadweight costs and the greater the avoidance of losses for all.

These considerations give rise to the second principle which officials should bear in mind when considering any type of debt:

"How to ensure that any future resolution of the collective action problem is resolved and resolved optimally". It is also the second principle this handbook uses to consider non-traditional debt.

The guide turns to each of these two principles and applies them to the provisions which are present in all debt instruments, commonly- used/traditional and novel/ non-traditional. These are provisions dealing with:

- Parties – their identity; their role; their substitution and any limitation on their substitution;
- Cash-Flow – [re]payment time of principal, interest, and other amounts (including any delays or accelerations to such time, and any variations/step-ups/downs in any of these amounts); contingent payments and "extras"; the source of payment (commodity sales, reserve accounts);
- Representations – capacity & authority; information and accuracy/ standards of information;
- Covenants – purpose/application of debt proceeds; information; status maintenance; security/negative pledge;
- Default – Non-Payment; Non-Compliance; Status; and Cross
- Defaults. Fragility and consequences;
- Administrative – amendments & waivers; confidentiality; payment mechanics; currency of payment and discharge; notices; miscellaneous "boiler plate";
- Governing Law, Forum, and Immunity Provisions – rule book, referee, safe haven (and limits to it).

The first chapter raises sets of detailed questions in respect of these provisions. The remaining chapters revisit them in context of specific debt instruments. The aim is to help officials arrive at a set of best practices when incurring debt suitable to the needs of their sovereign, and to keep these practices updated by answering these questions afresh – a process that should be on-going and for which expert external advice always sought.

In brief the first principle dictates that for each debt instrument officials should:

- account and incorporate that instrument in the sovereign's cash-flow and debt sustainability models for reporting, accountability, and day-to-day cash management purposes;
- consider (a) contingencies to ensure the sustainability of the sovereign's debt, (b) the purpose for which the funds have been raised and the manner in which they are being applied and (c) strategic and tactical debt management challenges;
- evaluate what is advantageous and what is onerous based on market and context of transaction;
- strive for uniformity of terms for each type of instrument and across instruments (but also deviate

from market practices where appropriate);
- balance the legitimate interests of creditors against those of the sovereign; and
- always seek expert advice.
- In brief the second principle dictates that for each debt instrument officials should:
- consider its contribution to the sovereign's GDP growth and the creditor's interest in it;
- assess the pricing in the context of such contribution;
- understand the structure, novelty, complexity, scalability, and ease of managing any new instrument;
- determine what investors are available and whom they should seek to attract. Can they be identified, are they new, are they "co-operative", what are their funding/capital costs, can they absorb losses easily, how large are they (type, amount, gravity), is there a process for binding "minorities";
- if they undertake the obligation as guarantor, evaluate the risks, and oversee the terms and performance of the guaranteed entity;
- evaluate carefully proposals for secured finance;
- consider the fragility of the arrangements by understanding the undertakings assumed and the default provisions;
- consider the provisions which ensure intercreditor equity and enable orderly management.

The remaining chapters consider specific forms of private sector finance in the light of the two features, the two principles, and the detailed questions they have generated. The second chapter covers secured finance in general, including the role of negative pledges, and then more specifically (a) project finance, (b) commodity- backed finance, and (c) receivables financing and securitisation. The third chapter considers new creditors and new instruments and more specifically (a) Islamic finance, (b) bank borrowing and loans (which, though not "novel", are always flexible and changing) and (c) plurilateral lenders. Key questions and take-aways for officials are also considered.

An executive summary cannot summarise such a wide range of topics. It can however give a glimpse of the approach through a couple of examples so as to arouse curiosity and whet appetite: (a) secured finance considerations and commodity-backed funding and (b) investor universe and bringing together creditors under conventional bonds and Islamic sukuk certificates. Secured finance can provide cheaper finance. It is a tempting particularly for less-developed, commodity-rich countries (an LDCR). But secured finance can also be the source of a number of problems which may impede economic development, create an uneven playing field among creditors, obscure the state of public finances and state assets, and disguise the true economic health of the sovereign borrower. It raises many questions some of which are:

- Is the proposed secured financing the sole option for accessing markets? Does it commit the sovereign to a narrow investor base? Is the financing part of a long-term strategy of economic growth, diversification and ultimate access to a broader investor audience on an unsecured basis?
- Will the proposed security interest be public/publicly registered?
- Will other creditors be capable of knowing about it?
- Will its accounting treatment reflect the state of the sovereign's assets and liabilities over time and not unduly inflate current assets and leave future liabilities uncovered? How is the transaction to be recorded, reported and accounted for? What will be its effect on debt management and sustainability?
- Does the proposed security (a) give the secured creditor a super-priority in times of debt distress and so provide an advantage to that creditor over other creditors; or (b) protect the ability of a project to be completed within the parameters of the initial legitimate expectations of both the creditors and the debtor; or (c) is it an incentive to a class of creditors of a certain class in return for finding a way out of an impasse in a collective restructuring?
- Are the proposed security arrangements consistent with the
- terms of the sovereign's other debt instruments?
- How will other creditors react to security arrangements which do not benefit them? Will this distance any other group of creditors narrowing the investor base of the sovereign? Will this cause a rift between creditors which may be disadvantageous during times when the consent of all creditors is needed?

The importance of asking these questions can be highlighted in certain commodity-backed finance arrangements. An LDCR may accept a pre-payment for future deliveries of a commodity. The LDCR accepts an up-front payment. In return the LDCR commits to deliver to the buyer enough commodity stock that, based on market prices prevailing at the time of each delivery, will generate enough proceeds to satisfy a pre-agreed repayment schedule. At market prices prevailing when the sale is agreed, the LDCR may only have to commit a certain percentage of its output in return for the pre-payment. The remaining percentage can also be sold and generate revenue for the LDCR which is not committed to the sale agreement. If market prices rise, the non-committed percentage of the commodity increases and with it the government's revenues. If, however market prices fall, the non-committed percentage of the commodity shrinks and in extreme cases may shrink to nothing. This leaves the LDCR without any available revenues and without and resources for the country's needs or which can be committed to repaying other creditors, including the IMF with a rescue package. If the transaction is not publicly transparent it will compound the difficulties causing surprise and mistrust. The handbook considers these problems and makes "best (or at least "better") practice" suggestions.

Investor universe. How broad an investor universe should a sovereign strive to have? How are relationships maintained and issues resolved when the investor identity is not always known? What should officials managing the debt of a sovereign consider? On the one hand, a broad range of potential investors is likely to increase the available financing options and lower the cost of the debt. Indeed, a sovereign's investor relations outreach should be broad, inclusive, and partially focussed on new types of investors who are likely to be "return players" and being investors for the long-term.

On the other hand, an increased diversity of creditor type exacerbates the collective action problem when a sovereign finds itself in distress. Each separate pool of creditor type will have to be both capable and incentivized to participate in a collective process, first within its own creditor pool and then within the wider group of the sovereign's creditors.

Officials should consider first and foremost (a) the needs of the sovereign for financing, and (b) determine who are the most suitable creditors for this financing. Additional considerations include:

- Are these new investors, or are they existing creditors, now investing through a new instrument? If these are new investors, is it worth reaching out to them or will it take a lot more time, effort, cost and regulatory hurdles to maintain them as investors - are they more of a burden than a benefit?

- If these are existing investors, are we cannibalising/ fragmenting an existing investor group or are we enhancing it? Even if we are fragmenting it, does this increase the scope for raising debt or not?

- Does the fragmentation result in an increase or a decrease of the collective action problem? Are the new investors likely to be more, or less, cooperative than existing creditors? Are they likely to be disruptive if something unforeseen is requested by the sovereign debtor?

- In respect of each creditor type and for each set of creditors in a debt instrument (a) how easy is it for these creditors to absorb losses in case of a debt distress, and (b) what is their funding cost and how might it vary (i) during the life of the debt arrangement, and (ii) if the funding arrangements have to be rescheduled?

- At any time, (a) how large is any specific creditor by (i) type, (ii) amount of exposure, and (iii) special gravity, and (b) how does each creditor's percentage participation in the overall creditor composition assist or impede a major reset of financial arrangements?

To decide on the identity and identification of creditors officials should ask questions such as:

- Where there is a record of creditors, are the ones on the record the ones who take the decisions?

- With whom do officials negotiate if they want to propose an amendment to the debt instrument's terms or seek a waiver in respect of some of the obligations it imposes on the sovereign?

Does it matter if all creditors cannot be identified? Is it possible, notwithstanding the inability to identify all creditors, to reach a decision based on the process prescribed in the debt instrument? Is there a way to negotiate, even through intermediaries, representatives or with representative groups?

Is there a process which is capable of resulting in a decision binding on all relevant creditors?

Sukuks are arrangements which seek to produce cashflows equivalent to the ones of bonds but consistent with Islamic law. Whereas bonds are debt obligations and entitle the holder to a stream of interest and principal payments over time, sukuk certificates represent streams of periodic payments deriving from the profits of a commercial activity, such as the lease of land. Investors in sukuk certificates are on the whole different from investors in bonds. For a sovereign, being able to reach a new class of investors is something very attractive, especially if these investors are growing in number and wealth. But sovereigns ought also to be wary both of (a) any additional regulatory and process management requirements and (b) even more acutely of how a crisis will be managed on a downside. The Argentina debt restructurings showed the importance of fixed income instruments (such as bonds and sukuks) having collective action clauses allowing supermajorities to accept resolution proposals from the sovereign and bind any dissenting minorities. The difficulty with the Argentinean restructurings gave birth to the technique of aggregating bonds across series to be capable, potentially, in having a single vote binding on all bondholders. Aggregating across bonds and sukuks is however a challenge. Can it be done? Does it matter that all sovereign sukuks so far are English law governed and none are under New York law? Though not yet tested, countries have grappled with the problem, and some have solved it. For details, including on the very important foundational principles of Islamic financing, and a lot more besides, the Guide "Key Considerations in incurring non-traditional debt" awaits you!

CHAPTER ONE

1. "WHY SHOULD I READ THIS HANDBOOK?"

1.1 Introduction

(a) You have in your hands a handbook entitled "Key considerations for incurring Non-Traditional Debt". What is "non-traditional debt"? Why is this debt important? Why should you read this handbook and indeed engage in conversation with it?

(b) The handbook is primarily for those within the civil administration of a country who are responsible for the country's debt management. These are likely to be debt management officials, finance ministry civil servants, central bank economists and relevant government officers, elected or appointed. They are likely to be economists, finance experts, civil servants in charge of finance and development, i.e., persons who understand why their country needs to raise debt, where and how the amounts borrowed need to be spent, how this contributes to economic welfare, how to manage the cash-flows of the debt, and what matters for the country's overall debt sustainability. Few of these "Officials" are likely to be lawyers with experience in the details of the debt instruments used to raise debt. Most only focus on the cash-flow provisions of their country's debt instruments. Everything else is the province of lawyers and mostly looked at only in exceptional circumstances.

(c) So, what is "non-traditional debt" and how does it differ from "traditional debt"? One way of making the distinction is this: "traditional debt" is the one most commonly raised from the most usual types of creditors – the "mainstream" way of raising debt. Correspondingly, "non-traditional debt" is less commonly raised debt and/or debt borrowed from new types of creditors. This is plain enough, but it tells us little on what debt instruments are traditional and what are not.

(d) The traditional/non-traditional distinction only makes sense for a determination made at a particular point in time by reference to the debt-raising practices of certain countries and any new emerging debt-raising practices for the same countries. For example, up to the end of the 1980s "traditional sovereign debt" for Latin American countries would have been loans from commercial banks and little else. With the introduction of the Brady Bonds[1], loans were mostly replaced by bonds and bonds would be then morph from "non-traditional" to "traditional sovereign debt".

(e) The list of "traditional" and "non-traditional" sovereign debt is longer today. Non-traditional can include new types of debt (such as Islamic debt instruments, commodity-backed finance, securitisations, leasing, certain forms of swaps, debt for nature swaps, debt contingent on the occurrence of various acts of God, particularly climate resilient debt instruments). It may also include more familiar types of debt such as loans provided by new lenders (e.g., Chinese state and commercial banks, specialised lenders from the hedge and credit fund world and "plurilaterals") or loans where the risk taker is not the lender of record (certain forms of export credit financings and sub-participations).[2] Some of these will be considered in more detail later in this handbook. With time, "non-traditional" debt instruments become "traditional", as understanding of them improves and their use expands. Ten years from now the lists for "traditional" and "non-traditional" debt will almost certainly be very different.

1.2 Intended audience and scope of

1 *See Public Symbol in Private Contract: A Case Study by Anna Gelpern and Mitu Gulati, SSRN, 26 Sep 2006 (here and here).*

2 *Some would argue that a few of these ways of raising debt are already traditional and mainstream.*

this handbook.

(f) Officials are tasked to raise and manage debt for their country and to do it as "best as possible". All can agree on the principle of an as "best as possible" debt management. But the specifics matter and so there will always be debate on what this means in practice. The debate centres principally on the appropriate debt instruments to be used for raising debt and the terms of these instruments. As noted, in ordinary times Officials will focus on the cash-flow provisions of the available debt instruments. Other features may be relevant, but most of the time their relevance is judged principally by how the overall funding of the sovereign becomes less-costly and the cash-flow better managed. The relatively little-used bonds of the 1980s now dominate. Their tradability, their liquidity, the ancillary instruments and markets developed to facilitate trading, are all parts of a large efficient market which Officials understand and use well. Their era was preceded by a long and mostly calm period of sovereign financing provided by bank lending. This ended when rising dollar interest rates and minimal capital provisions for loans to sovereigns combined to bring about the impasse of the "Lost Decade" where sovereigns could not afford the debt and banks could not afford the write-offs. The sovereign bond's trajectory from obscurity to current ubiquitousness was marked with its own upheavals and challenges. In both cases, the stresses exerted by financial crises revealed its vulnerabilities and fault lines.

(g) The fault lines were in the fundamental assumptions about the financial resilience of both debtors and creditors, and/or in the adequacy of the debt instruments deployed. The assumptions which led to the Lost Decade was that interest rates would remain stable and that banks do not need capital buffers for their sovereign loans, because "countries don't go bankrupt"[3]. The most famous of the bond vulnerabilities were (a) the absence of any collective action clauses (CACs) from NY law governed bonds[4] and, following their introduction, (b) the absence of a means to bring together all bond issuers under a single voting mechanism, an aggregated across series CAC.

(h) These fault lines and vulnerabilities stem from two features which make sovereign debtors radically different from any other debtor. The first is that sovereign debt is a public good, whereas for all private entities debt is a private facility. The second is that bankruptcy for sovereigns means something very different than for private entities. Examining these features helps identify what really matters in any sovereign debt instrument, particularly a non-traditional one where the relative absence of historical experience has not as yet revealed its particular weaknesses.

(i) The rest of this handbook will consider these two features. Then, by reference to these features it will articulate principles for determining what should be key concerns for sovereign debtors when they consider sovereign debt instruments. It will then consider the basics of all sovereign debt instruments followed by a consideration of certain current non-traditional debt instruments by reference to these principles and by what may be novel or unfamiliar about them.

(j) The discussion will not cover all the features of the selected debt instruments. Drafting and negotiating these debt instruments will, each time, require expert assistance. The hope is not only to inform, demystify and clarify some of this new, non-traditional debt, but also to analyse it in a way that can be used to understand any further, new forms of non-traditional debt, either not discussed here or not yet devised.

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3 *Attributed to Walter Wriston, Chairman of Citibank. Volcker, Paul, Keeping At It, published by Public Affairs 2018, page 133. The book records (page 146 and elsewhere) Walter Wriston's dismissal of the need for more bank capital.*

4 *English law bonds had collective action clauses, as indeed did the NY law bonds until 1933 when a set of new acts set to protect investors and regulate bankruptcies led to their removal from corporate bond issues. Alas the removal was extended into sovereign bonds, a practice which continued until the early 2000s.*

2. WHAT MAKES SOVEREIGN DEBT AND THEIR STATUS AS DEBTORS UNIQUE?

2.1 Sovereign debt as a public good.

(a) Sovereigns raise debt to protect themselves and enhance the welfare of their citizens. Sovereign debt can and has financed all of the following: the defence of the sovereign realm, crucial infrastructure projects (transportation, schools, hospitals, utilities etc.), the establishment of social programmes, and the relief for public emergencies (natural disasters, pandemics etc).

(b) In addition to the sovereign, other entities whether sub-nationals (e.g., states within a federal sovereign, provinces and municipalities), enterprises owned or controlled by the Sovereign (e.g., state owned enterprises (SOEs) such as electricity producers and distributors, or water and waste management companies) or institutions systemic for the economic functioning of the Sovereign (e.g., large banks) may raise debt. The ability of these entities to raise debt almost always depends on the ability of the sovereign to raise debt and there will be circumstances where the sovereign will have to assume the burden of their debt, either expressly through guarantees or implicitly, to preserve and provide the essential functions and services expected of it.[5]

(c) More generally, all companies and businesses operating within the jurisdiction of a sovereign depend on the ability of the sovereign to raise debt and its credibility to sustain it. The quality of the sovereign's debt is the basis of financial reliability for domestic economic growth and hence the welfare and prospects of its enterprises and citizens.

(d) Sovereign debt is, therefore, a public good, and sovereign debt management is something which is expected to be exercised for the benefit of the public, as part of overall good governance.[6] How the "benefit of the public" is determined is a complex matter. Political parties, citizen associations, the press, experts and individual citizens all advocate their preferred choices and argue for their desired outcomes, but always stating that what they stand for is for the public interest and benefit. Ultimately, and in all cases, the "public benefit" is determined by the dynamics of the sovereign's domestic political economy, which, by their nature, evolve over time.[7]

2.2 Corporate debt, a facility to pursue profits.

(a) Corporates, by contrast operate on a simple model. Corporates have a clear "equity" part in their capital structure. Their aim is to increase their profits and maximize returns to their shareholders. Maximising the "return on equity" is the principal goal of a corporate.

(b) Shareholders are a more compact and uniform group than the "public" and they and their companies often take risks that they would not be prepared to take as citizens of their country.

(c) Even when companies state that their aim has a broader "social responsibility" (e.g., through commitment to ESG goals), this is interpreted and implemented through the lens of the company's long-term profitability and value for its shareholders. In the context of this profit seeking, debt is one of the most important tools for the promotion of a company's aims. The reference to "debt" as "leverage" on the equity capital is indicative of the role that

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5 *Where the Sovereign expressly guarantees or otherwise underwrites debt of other entities, the legal forms of some of this debt will be part of this handbook's discussion. On the other hand, the broader topics of SOE financing and the benefits to a Sovereign of the credibility of its debt commitment are outside the scope of this handbook.*

6 *For a general discussion of the origins of modern public debt and its many uses see In Defense of Public Debt, Barry Eichengreen, Asmaa El-Ganainy, Rui Esteves and Kris James Mitchener. Oxford University Press, 2021. The most forceful defence of sovereign debt as a public good has been made by Alexander Hamilton in The First Report to the House of Representatives on Public Credit 9 January 1790 (text here).*

7 *Cases of breach of public trust where sovereigns and those governing them fail in discharging this duty underscore the essence of this nature.*

debt is considered to have in the growth of a business: a tool that multiplies the financial commitment, the equity, of shareholders. Debt is in this context is not seen as a public good which must be preserved and safeguarded, but as a private facility which is exposed to risk and may fail.

2.3 Cost of capital, sovereign debt as sovereign equity.

(a) The difficulty in assessing the "public benefit" purpose of sovereign debt, and the fact that all of the domestic economy depends on the ability of the sovereign to raise debt and its credibility to sustain it, makes the calculation of its cost a complex matter, which is not just measured by the pure cost of interest, however crucial this might be. A slightly more expensive debt, whose terms are familiar/traditional and provide flexibility, and whose holders can be counted on to co-operate in times of need, may be more advantageous than debt cheaper by a few basis points, whose holders are new and form a distinct group, whose terms are untested and whose management may prove impossible in times of financial stress. By contrast, corporate debt is there to magnify the return on the equity and hence its cost is of paramount importance. Concerns about what happens in times of ultimate stress are also very important to corporates but cost of debt considerations will prevail over unusual debt features. The unusual and the novel in corporate debt instruments will be swept in by the bankruptcy rules and be normalised by the process of the prescribed loss-allocation rules.

(b) This will not be the case for debt raised by sovereigns, and not only because of the public benefit purpose of sovereign debt. Although it has the debt characteristic of having to be paid "in full and on time", sovereign debt also serves as the sovereign's equity. The special nature of the sovereign debtor and its ultimate sovereignty, which allows it to determine who can be paid and when, means that at times of debt distress the debt claims are brought on a par with other obligations of the sovereign and even suffer *de facto* subordination. At such times, the sovereign can proceed with loss-allocation in a bespoke way among all creditors and types of claim, domestic, external, social, financial, etc. The organising principle of this loss allocation is not a formal "debt over equity" type seniority, but an overall proposal to all constituents, domestic and external. It is an overall proposal which aims credibly to take the sovereign out of the crisis and return it to prosperity.

2.4 Accountability and transparency.

(a) How debt is recorded and how the obligations are assessed by reference to the expected benefits is a concern for both corporates and sovereigns. Accounting and disclosure for corporates is an easier task than for sovereigns. Given the simple pursuit of profit, owners of the company will want to have as clear and complete a picture as possible to assess whether the pursuit is being successful, and the fruits of the success appropriately distributed. Where the corporate is a public company, the relevant jurisdictions mandate levels of disclosure and standards of accounting with which the corporate must comply. The declared goal is to permit the owners and others having a financial exposure on the corporate to assess its financial performance.[8]

(b) Sovereigns accounting and calculations on the proper way of accounting for the sovereign assets and determining the sovereign debt sustainability are far more complex than those of corporates. This reflects the relative complexity of the respective goals of a sovereign and a corporate. Given this complexity, sovereign accounting and calculation of debt sustainability are a continuous work-in-progress.[9] Properly accounting, recording, and incorporating into

8 *It has to be acknowledged that notwithstanding all that, when a corporate uses for the first time a new, non-traditional instrument for raising money, the existing standards and requirements may prove to be insufficient in accounting and disclosing it properly. However, it is easier for the regulators to update the standards and requirements, a task which is part of their overall mandate.*

9 *The topics of appropriate sovereign accounting principles and public disclosure requirements and duties are outside the scope of this handbook. For an introduction to the issues, please see the Revised Guidelines for Public*

the cash-flow and debt sustainability models any new financing is the core function and professional challenge of debt-managing Officials. The challenge can be even greater for new instruments whose form may be familiar, but whose providers or whose purpose may be new. "*How to account for a [non-traditional] debt instrument, how to incorporate it in the cash-flow and the debt sustainability models and how to approach its non-financial provisions*", should be an overriding aim of Officials. It is also the first principle this handbook proposes to use in relation to its discussion of both traditional but principally non-traditional debt. The principle is two-fold. It is first and foremost a quantitative principle underscoring the importance of proper recording and accounting of cash-flows, returns, and contingencies. It is also a qualitative principle focussing on the non-financial terms which may prove to be onerous and limit the flexibility of Officials.

1.3 Sovereigns are special debtors.

(c) The second feature which make sovereigns radically different from any other debtor is that sovereigns are the creators of [domestic] law and so, in a sense, "above the law". Sovereigns cannot be legally coerced. They enjoy "state sovereignty" which means that no one else is entitled "to intervene in matters which are essentially within the[ir] domestic jurisdiction …"[10]. Every state, no matter how large or small, is sovereign and its sovereignty confers immunity on it, its acts and its assets around the world.

(d) A consequence of sovereignty is that there are no hard legal constraints on a sovereign – except the ones the sovereign expressly accepts. This matters for both debt management and overall accountability, including accountability for the debt management.

(e) A sovereign debtor can accept legal constraints on its debt such as an external system of law to govern its debt obligations and can waive its sovereign immunity[11]. Nonetheless, these constraints are limited and the sovereign is still free of external legally mandatory compulsion.[12] Circumstances may be very pressing, a number of other persons (creditors, multilateral organisations and other sovereigns) may have strong views on what the sovereign should do, and the choices that the sovereign has may range from poor to abysmal. Still, none of these amounts to a legal compulsion. It is the sovereign that chooses what constraints it will accept. At an extreme a sovereign can decide whom to pay and whom not to pay – for the sovereign this is just a matter of overall cost/benefit analysis.

(f) Sovereigns overall choose to honour their commitments. They choose to respect the rule of law. When they cannot meet all their financial obligations, they overwhelmingly choose to follow a fair process. In neither case do they do it under any external legally mandatory compulsion. They make these choices because, in their cost/benefit calculus, almost all sovereigns place a high value to the honouring of their commitments, to a fair process and more broadly to the rule of law, as these enhance their continuous credibility and allow them to develop economically and prosper in the community of nations.

(g) The special nature of a sovereign debtor becomes even clearer in the more challenging times, where it has lost market access and, even with the adoption of an IMF reform program, its debt is not sustainable without a

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Debt Management, IMF publication 1 April 2014. On the general topic of proper accounting and disclosure, see the IMF's paper Making Public Debt Public—Ongoing Initiatives and Reform Options, 31 July 2023 (here).

10 *See Article 2.7 of the Charter of the United Nations.*

11 *Technically, the immunity of a sovereign before its own courts is referred to as "sovereign immunity" and before foreign courts as is called "state immunity".*

12 *It could be countered that one sovereign, Argentina, found itself under such a mandatory legal compulsion in the case of its famous litigation before the New York courts, NML Capital, Ltd., v Republic of Argentina, 727 F.3d 230 (2 Cir. 2013). Strictly speaking the mandatory legal compulsion was not on Argentina itself, but on the global payments system which Argentina was obliged to use. Arguably, the case was unique and so unprecedented that even the judge who made the order refused subsequently to follow it.*

restructuring imposing losses on its creditors.[13]

(i) Creditors can at best obtain a judgment against the sovereign in respect of overdue payments (or other breaches) when suing in the designated courts. Creditors on the other hand will never be able to enforce against the domestic assets of a sovereign debtor. The waiving of immunity combined with an appropriate foreign governing law will confer on the creditor, at the most, the rights (A) to assert its claim subject only to the contractual terms of the debt instrument and (B) to seize the sovereign debtor's assets outside the sovereign's jurisdiction, subject to the state immunity statutes of the jurisdictions where these assets are situated and of the debt instrument's governing law.

(ii) At the same time a sovereign debtor can never write down its debt unilaterally. This can very well lead to an impasse with the sovereign requiring its creditors to assume losses and the creditors refusing. The conflict will remain unresolved without any finality, unless the sovereign and its creditors agree on a solution.[14]

(h) By contrast, corporates are the creatures of the laws of a particular sovereign and are subject to them. Faced with financial distress they and their creditors know that resolution and finality can be achieved by following what the law prescribes: the corporate directors will be called to account; the corporate debtor's assets will all be identified; the creditors will be ranked according to a pre-existing priority ladder; the allocation of the corporate's assets (and corresponding losses) will proceed in a certain and clear way; last but not least, the debt will be discharged in the process. This allows them to pursue consensual resolutions either under the protection of bankruptcy laws or under their shadow, knowing that these laws set the parameters of a certain finality. This is the way millions of corporates end their life and it is part of the bargain that all its creditors accept when dealing with corporates and the ventures they pursue.

(i) Notwithstanding the lack of a set of external rules which set the parameters of finality, sovereigns and their creditors do on the whole reach consent when sovereigns find themselves in financial distress and a debt restructuring is inevitable as losses will fall on both the debtor and its creditors. This is true even when the types of creditors are increasingly diverse. The following two assumptions (the **Assumptions**) serve as the grounding premises for the building of this consent:

(i) following the debt restructuring, the sovereign debtor will be able to grow and return to prosperity; and

(ii) the debtor/creditor relationship is long-term and symbiotic, meaning that the sooner the sovereign's economy returns to growth, the fewer the overall deadweight costs will be and the greater the avoidance of losses for all parties.

(j) If only one creditor and one debtor were involved, consent would be simpler and quicker to reach. The large number and diversity of a sovereign's creditors changes the calculus considerably. To resolve the ensuing collective action problem, the sovereign and its usual lender of last resort, the IMF, deploy a series of incentives and disincentives, which together seek to force the creditors to act as one and accept the economic benefits of the Assumptions. "*How to ensure that any future resolution of the collective action problem is resolved and resolved optimally*" should be

13 *See The Sovereign Debt Restructuring Process by Lee Buchheit, Guillaume Chabert, Chanda DeLong and Jeromin Zettelmeyer in Sovereign Debt: A Guide for Economists and Practitioners, edited by S. Ali Abbas, Alex Pienkowski, and Kenneth Rogoff. An earlier version of this chapter can be found* here*. See also part 6, Special Debtors in Principles of International Insolvency (volume 1 of Law and Practice of International Finance), by Philip Wood, Second Edition, Sweet & Maxwell, London 2007 and Philip Wood, Corporate, Bank and Sovereign Insolvencies: Why the Difference? Business Law International, Vol 22 No 3, September 2021n*

14 *This and the subsequent paragraphs draw on the discussion on the impasse, the lack of finality and the role played by law in corporate restructurings in* Debtor–creditor engagement in sovereign restructurings*, by Yannis Manuelides, Capital Markets Law Journal, Volume 13, Issue 3, 1 July 2018.*

another overriding aim of Officials. It is also the second principle this handbook proposes to use in relation to its discussion of non-traditional debt.

1. THE BASIC FEATURES OF DEBT INSTRUMENTS

(a) The fundamental structure of a debt instrument is always the same: a person (the "*borrower*" or "*debtor*") raises/borrows an amount of money (the "*debt*") from [an]other person[s] (the "lender[s]" or "creditor[s]") and agrees to pay it back with interest on certain dates. It is the payment "in full" and "on time" of fixed amounts of principal and of determinable[15] amounts of interest (the "*debt service*") which makes debt "debt". If the payment obligations are contingent in quantum or due dates, then the payment obligation becomes something other than debt.[16]

(b) At its core, therefore, "debt" is a series of fixed or determinable amounts due on specific dates. It is the payment, the "servicing" of this cash-flow element of debt that mostly concerns Officials. Failure to pay in full and on time has serious consequences for the sovereign they serve. What else should Officials care about?

(c) Debt instruments almost always contain other provisions besides the ones recording the borrowing and the obligation to make the periodic payments in full and on time. Very broadly, the provisions of debt instruments fall into seven categories:

   (i) those which identify parties (the debtor, any other persons assuming the obligations of the debtor (the obligors), the creditors and the persons who assume the administration of the debt) and the provisions addressing how they will interact and how and who can replace them (the ***Parties Provisions***);

   (ii) those which specify how amounts can be borrowed, when these borrowing have to be repaid, how interest is to be calculated and when it should be paid, whether any other amounts are payable (e.g., taxes) to ensure the creditor receives what it has bargained for (the ***Cash-Flow Provisions***);

   (iii) the certifications that the debtor provides to the creditors as to its identity, its capacity and authority to do what is contemplated in the debt instrument, the existence of any material claims against it, the absence of defaults in other debt instruments, the accuracy of the IMF' Article IV reports, the reporting of data in accordance with certain standards, the current ratings of the sovereign, the ability to waive sovereign immunity, the absence of adverse taxes and other adverse consequences for the creditors etc. (the ***Representations Provisions***);

   (iv) those where the debtor promises to use the amounts borrowed for a specified purpose, and, as long as it is a debtor, to conduct itself in an agreed manner, to provide appropriate information about itself, its economy, any material claims against it, the imposition of sanctions against it etc., (the ***Information Covenants***), to keep its assets unencumbered (subject to exceptions) – the ***Negative Pledge Covenant***), to maintain its membership in international organisations, etc., (together, the ***Covenants Provisions***);

   (v) those that set the conditions which entitle the creditors to terminate the arrangements ahead of their originally agreed time and

15 *"Determinable" is used to refer to amounts of "interest" payable periodically either as a "fixed" percentage on the debt amount (e.g., 5%) or as "variable" percentage depending on a reference rate such as EURIBOR (e.g., 2%+ EURIBOR).*

16 *It may be countered that in sovereign debt there is a growing interest in instruments which are classified as "debt instruments" but whose payment is contingent on certain events, notably natural disasters affecting the sovereign debtor's ability to pay. Climate resilience debt clauses in debt instruments such as loans and bonds may shift the due dates of the amounts due on the occurrence of certain climate contingencies. See the* **ALSF Debt Guide on State Contingent Debt Instruments**. *However, these clauses are used only in sovereign debt instruments, not in the debt instruments of other debtors.*

to ask for the early repayment of the borrowings (the ***Default Provisions***). Default Provisions fall into three types. First, the ones that tie termination rights with the debtor's compliance with the terms of the debt instrument. These include breaches of obligations to make payments in accordance with the Cash-Flow provisions (the ***Non-Payment Defaults***), non-compliance with the Covenant Provisions, inaccuracy of the Representations Provisions, or unlawfulness or repudiation of the debt instrument (the ***Non-Compliance Defaults***). Second, the ones which relate to the overall status and financial health of the debtor. In the case of a sovereign these include the declaration of a moratorium, membership of and ability to draw funds from the IMF, or its entering into negotiations to restructure its debt with other creditors (the ***Status Defaults***). Third, the ones which relate to the debtor's non-compliance with other debt instruments, e.g., non-payment, non-compliance or inaccuracy by the debtor in a specified set of other debt instruments to which it is or may become a party (the ***Cross-Defaults***);

(vi) those that deal with all the administrative and process aspects of the agreement (the ***Administrative Provisions***). The Administrative Provisions include those that provide how changes to the agreement will be made (***Amendments and Waivers Provisions***), how notices are to be exchanged between the parties, where and how payments are to be made, what level of confidentiality should be maintained (***Confidentiality Provisions***), who can be parties to the agreement and what changes to the parties are permitted (***Party Identity and Changes Provisions***) and a host of other provisions which are important for the orderly administration and interpretation of the debt arrangement; and

(vii) those that designate the rules regulating the arrangements and the referees if there is any dispute between the parties (the ***Governing Law, Forum/Tribunal and Immunity Provisions***).

(d) If all these provisions are present in the debt instruments used by sovereigns, which ones, other the Cash-Flow Provisions, should be of particular concern to Officials? And what features in any of these provisions make the debt "non-traditional"? The general, and slightly pedantic, answer is "all provisions should be of concern to Officials" and even small changes in any of them can make the debt 'non-traditional'". To help Officials understand on what they should be focussing and how to evaluate the relative importance and weight of these provisions and what changes matter in making a debt instrument "unusual", we should look at the two principles identified earlier:

(i) "*How to account for a [non-traditional] debt instrument, how to incorporate it in the cash-flow and the debt sustainability models and how to approach its non-financial provisions*"; and

(ii) "*How to ensure that any future resolution of the collective action problem is resolved and resolved optimally*".

2. EXPANDING THE TWO PRINCIPLES –IDENTIFYING KEY FEATURES – RAISING QUESTIONS

(a) Each of the two principles identified earlier can be expanded further to allow a more detailed approach in understanding the features of sovereign debt instruments.

(b) First we articulate some important features of these principles and then we raise a set of questions around them. This is because each sovereign's political economy is different and the drivers and opportunities for raising debt will depend on each sovereign's specific and individual circumstances.

(c) We then consider some non-traditional debt instruments which will highlight why these features are important and the challenge in answering some of these questions.

(d) The questions can be common, but the answers will always be different, owing to the specific and individual circumstances which are particular to each sovereign. The aim of the handbook and the presentation through the principles, the key features, the cluster of questions and the consideration of some debt instruments is not to provide overall guidance or arrive at universal conclusions. The aim is to help the Officials of each sovereign to arrive at a set of best practices suitable to the needs of that sovereign. It is hoped that the best practice of all will be one where (i) the two principles are examined and re-examined, (ii) the key features expanded and amended and (iii) the questions raised again and again and answered afresh to address the changing circumstances and interests of the sovereign.

2.1 Accounting and modelling – Cash-Flow and Debt Sustainability

(a) The quantitative part of the first principle concerns the "proper accounting and incorporation in the sovereign's cash-flow and debt sustainability models of a debt instrument". Officials need to be able to record and report on the Cash-Flow provisions of the relevant debt commitment.

(b) <u>The recording must be capable of being complete</u>:

(i) <u>for reporting and accountability purposes</u>. Reporting and accountability is first and foremost necessary within the debt management agency and to relevant government officials for their own proper functioning. Without complete and accurate information, neither can discharge their duties in an appropriate way. More broadly, reporting and accountability is due to international organisations, to investors, and the public as required by applicable laws and disclosure obligations;

(ii) <u>for day-to-day cash management purposes</u>. If the owed amount is unrecorded, material and there are no stand-by reserves, the liquidity position of the sovereign may be challenged in unforeseen consequences. Even if the owed amount is not material, orderly cash management requires advance planning and the tapping of stand-by reserves for truly extraordinary purposes. Indeed, proper cash management requires the regular review of all unbudgeted and/or extraordinary requests for payments to determine whether any of them could have been incorporated in the budget and cash management.

(c) <u>The accounting must consider future contingencies and eventualities and seek to address them as much as possible to ensure the sustainability of the sovereign's debt position</u>. This includes:

(i) <u>the broad purpose for which the borrowed funds have been raised and the manner in which they are being applied</u>. Decisions on this may be outside the mandate of debt management Officials. Nonetheless, the specific and/or overall contribution to the economy of borrowing is still a task of government and to be properly discharged accurate data must be maintained;

(ii) <u>strategic debt management challenges</u>. Is the interest rate fixed or floating (contingent on some external rate)? If floating, will the sovereign's revenues follow the same trend matching the fluctuations? If not, what reserves/buffers are available to meet any likely increases? What can be done to mitigate extreme fluctuations?

(iii) tactical debt management challenges. Are there any other payments which may arise and when? Can these constrain the ability of the Officials to manage the debt? Examples of such payments are "breakage costs", "make-whole" amounts, creditor costs contractually burdening the debtor (e.g., cost of funding increases, regulatory costs, exceptional administrative costs, etc.), and costs for obtaining waivers and consents.

(d) Practically speaking this leaves Officials with the following questions to raise when dealing with any financial instrument:

(i) Is it possible to account and report the cash-flows for cash management purposes? Is there anything which could lead to additional payments and how will these contingencies be recorded and monitored?

(ii) Do the proposed terms expose the sovereign to not only to any unforeseen additional payments, but to a situation where it might find itself with few negotiating options to resolve a distress (e.g., because it has committed the bulk of its revenues to the creditors of that instrument)?[17]

2.2 Non-financial terms.

(a) The second, qualitative, part of the first principle seeks to find the right approach in relation to the non-financial terms of its [non-traditional] debt instruments. In practice this means all of the provisions identified above, other than the Cash-Flow Provisions. Evaluating what is advantageous and what is onerous in a debt instrument depends, at first instance, on the prevailing market trends for the relevant type of debt and the context of the specific transaction. These terms will evolve over time as the market dynamics evolve and as both creditors and debtors discover vulnerabilities in terms previously found acceptable which adversely affect their respective legitimate interests. Officials should always seek advice from appropriate advisors, financial and legal.

(b) The terms of the debt instrument will always need to have a minimum of terms which are appropriate and legitimate to the relevant debt arrangement. What is appropriate in an unsecured, foreign currency, external law syndicated loan is very different to what is appropriate to domestic currency, domestic law and domestically traded note issue. Each debt instrument type will therefore have its own documentation and its own provisions, appropriate and legitimate to it.

(c) Market practice does evolve and may lead to important differences in terms over time. It is important that Officials stay abreast with current market practices, so that they are able to maintain the maximum coherence and flexibility within each relevant market. Markets for the more traditional forms of debt themselves strive for consistency and coherence. Their aim is to facilitate transactions and to allow participants to focus principally on the financial/Cash-Flow terms, making the non-financial terms part of an enabling infrastructure which can be left mostly alone. Professional associations in some of these markets seek to standardise the drafting of provisions and codify practices to promote certainty and tradability in their market.[18]

(d) Sovereign debtors should aim for uniformity of terms for each type of debt instrument. Having

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17 *See for example discussion in section 1 (What is Commodity-Backed Finance?) of Schedule 1Part 2*

18 *In the capital markets this is done by ICMA (here), the International Capital Markets Association. In the derivatives market this is done by (here), the International Swaps and Derivatives Association. In the English and European law bank loan markets this is done by the Loan Market Association (**LMA** - here). In the US law bank loan markets this is done by the Loan Syndications and Trading Association (**LSTA** - here). In the UK the Association of Corporate Treasurers (ACT) publish commentary on the LMA loan precedents from the perspective of the corporate borrowers – here for The ACT Borrower's Guide to the LMA's Investment Grade Agreements and here for The ACT Borrower's Guide to Sustainability-Linked Loan Terms)*

different collective action clauses in each of its bond issues may prove to be a very expensive mistake as determined free riders block the process or ask for something excessive or inappropriate. Having different Information Covenants, Negative Pledge arrangements or Default Provisions in each of its 10 syndicated loans is bad debt management for any debtor. Having different "Business Day" definitions in derivative instruments, especially ones whose payments are interdependent, can prove problematic. Having different Administrative Provisions in the debt instruments of the same type can be confusing and very likely lead to mistakes. Such disparities make monitoring and compliance unnecessarily complex and the terms, even if each one of them is benign in itself, will collectively become onerous.

(e) Still, Officials should recognise that consistency with market practice and uniformity are not always appropriate. There may be good reasons to deviate, especially when the circumstances require something bespoke. Legitimate national interest reasons and appropriate purposes for the borrowed funds, or a unique opportunity to raise funds in a commercially advantageous manner are good examples of such reasons. What is always important, however, is to ask all the remaining questions suggested in this handbook in relation to this new bespoke debt instrument. This will allow a proper justification for the deviation; it will allow for proper authorisation of the persons executing the debt instrument on behalf of the sovereign and will be the basis for any need to account for the particular choice and so demonstrate it was done for legitimate reasons and after appropriate diligence.

(f) Officials seeking to negotiate appropriate terms in the debt instruments must do so in a measured way. Creditors advance funds to debtors and, in unsecured transactions[19], what they get in return is a promise for repayment as recorded in the debt instrument. In the case of sovereign debtors, the promise is tempered by the shield of sovereign immunity.[20] Creditors do, therefore, have a legitimate interest in having terms in their debt instruments which protect in an appropriate way this legitimate interest. Officials should not seek to antagonise creditors over points which are legitimate or reasonably accepted by current market practice. Creditors, or at least certain of them, should be seen as the long-term partners with whom Officials have to work on behalf of their sovereign. In addition to appropriate financial terms, what Officials should ensure is that the proposed debt instrument is market appropriate, overall uniform for the type of debt instrument and specific obligation undertaken, and consistent with the debtor's overall practice.[21]

(g) Officials need to be aware that in periods of debtor distress, especially when large segments of the market are affected, or the distress is held to be "systemic", past practices will often be re-examined and new standards and common templates introduced. For the sovereign debt markets the most famous standardisation effort was the one which followed the Argentina litigation.[22] In this instance, the *pari passu* provisions in NY law governed bonds which had been drafted in a manner consistent with what the markets expected at the time of their issue, were interpreted by the NY court in a manner which the markets did not expect. Coupled with the unusual remedy granted by the NY court and the absence of a mechanism to overcome the collective action problem, the debtor and creditor community settled a new set of (A) collective action clauses for bonds aggregating over a number of different series of bonds and (B) a *pari passu* clause.[23]

2.3 "How to ensure that any future resolution of the collective action problem is resolved and resolved

19 *Secured arrangements are discussed in Schedule 1 (Secured Finance – Project, Commodity-Backed, and Receivables Financing).*

20 *See 2.5(e) above.*

21 *See discussion on uniformity of CAC provisions in 3 (Multiplicity of Instruments and investors - Unity of Management of Schedule 2Part 1 (Islamic Finance - its main principles – mitigating uncertainty).*

22 *NML Capital, Ltd., v Republic of Argentina, 727 F.3d 230 (2 Cir. 2013).*

23 *See the standardisation on ICMA's webpage here.*

optimally".

(a) For Officials staying abreast of market developments and maintaining consistency and uniformity in a sovereign's debt instruments, however good a practice it may be, may still not be sufficient to identify what may turn out to be an onerous provision. This is one of the lessons demonstrated by the Argentina litigation. Market practices and conventions as well as specific provisions in debt instruments, even if consistent with market practice, are more likely to reveal themselves as advantageous or onerous during periods of debt distress.

(b) If that is the case for traditional debt instruments, the risk also exists even more so in the less tested, novel, non-traditional debt instruments. Unpacking the *second principle* identified earlier, that of "optimal resolution of the collective action problem in times of sovereign distress" can provide some guidance on what one should want to consider in any debt instrument, particularly a non-traditional one. Unpacking this second principle is not only important for the times of sovereign distress. It is also important for ordinary times when Officials want to proceed with orderly and solvent restructuring of the sovereign's debt. The collective action difficulties will also emerge during such an exercise undertaken at ordinary times. Terminating early some of the debt arrangements, replacing them with novel instruments, and obtaining the consent of creditors for necessary changes without great cost are matters which Officials should be capable of achieving during ordinary times as well.

(c) As noted in 2.5 above that, when sovereigns find themselves in financial distress and a debt restructuring is inevitable with losses falling on both debtor and creditor, resolution built on consent is mostly (if not always quickly) achieved and that consent is grounded on the two Assumptions: that the sovereign will be able to return to prosperity and that the overall deadweight costs and losses will be minimized the sooner such return happens. The Assumptions make the case for a swift consensual resolution overwhelming. However, the structure of novel, non-traditional debt instruments and the number and diversity of creditors complicates a process which can already be very difficult because of domestic political economy challenges and geopolitics. When choosing to enter into any new debt arrangement, but especially one which is novel, non-traditional, Officials should consider all of the topics covered below.[24]

2.4 Contribution to GDP growth/other strategic goals

(a) Whether and how any new borrowing contributes to the economy of the sovereign debtor will always be answered through the process of the domestic political economy. Nonetheless, Officials should consider the following questions. Where these questions exceed their mandate, Officials should, where possible, raise them with the relevant branch of government:

(b) What are the [new] creditor's reasons for investing? Is the creditor just after a monetary return, is it to promote its own country's exports to (and overall trade with) the sovereign debtor, is it because it is interested in the sovereign debtor's commodities, is it for some type of solidarity (e.g., based on humanitarian assistance or based on ethnic or religious affinity), is it for overall geopolitical influence?

(c) What is the sovereign debtor getting out of this? Is it likely to see an increase in its GDP, in its core domestic economy, in the growth of skills etc? Is it likely to avert an imminent danger posed by climate, health or security risk?

(d) Is the new creditor one who has a long-term stake in the sovereign's economic growth and future?

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24 The list is a non-exhaustive set of questions. Many of the questions are just indicative. The questions are meant to get Officials to start considering the issues themselves by reference to the facts facing them and their country. It is expected that Officials will generate their own sets of more detailed questions appropriate to their circumstances.

2.5 Pricing/Cost

(a) The real costs of novel debt arrangements may not always be obvious when these arrangements are entered into. Whereas Officials are certain to check how the Cash-Flow Provisions operate in ordinary times, the novelty of the debt instrument and the lack of relevant experience may not permit them to focus sufficiently on what the cost will be in times when a restructuring will be advisable or required. Officials should consider questions like:

(b) What financial obligations does the new debt instrument impose on the debtor in case of an early termination or modification of the arrangement?

(c) Are these financial obligations clear, predictable and non-excessive?

(d) If these financial obligations are excessive, is their size likely to influence the sovereign, not to terminate and to exclude this instrument from the debt perimeter of an eventual restructuring? What constraints would that bring to debt management in ordinary times and in times of distress?

2.6 Structure and novelty of the debt instrument

(a) The complexity, novelty, scalability and/or uniqueness of the debt instrument is somethin which needs to be considered very carefully. Officials should consider questions like:

(b) Is this instrument novel/non-traditional? If so in what exactly does its novelty consist of? How does the novelty enhance or constrain debt management? How much time and outside help will be required to (i) understand, (ii) enter into, (iii) and manage, on an on-going basis, this new instrument?

(c) Is this instrument complex? Is the complexity justified by the nature and purpose of the instrument? Is the complexity justified by (i) the purpose of funds or (ii) the types of potential investors it brings into the universe of potential investors for the sovereign?

(d) Can the instrument be scaled or is it so bespoke that it cannot really be replicated in other circumstances? If it can be scaled, does it bring in a new class of investors worth pursuing, or will it cannibalise and fragment the universe of existing investors? If it is too bespoke, is its uniqueness justified by the cost or the use of the funds?

2.7 Governing Law and Forum Provisions.

(a) The Governing Law and Forum, the "*rule book*" (governing law) and the "*referee*" (forum/tribunal for adjudicating disputes) provisions, are two of the most important provisions of any debt instrument. Officials have to consider the choice well, even if their real choice is limited.[25]

(b) It is assumed that all non-traditional debt instruments considered in this handbook will be governed by a governing law other than the domestic law of the sovereign debtor. Such an external law is intended to "insulate" the creditors from domestic law changes enabling the sovereign debtor to use the "local law advantage".[26]

(c) Equally, it is assumed that the tribunal for adjudicating any disputes will be the courts of the chosen law or an arbitral tribunal familiar with it, but resident outside the debtor's jurisdiction.

(d) Where the debt instrument is governed by domestic law, Officials may wish to consider whether it is sufficiently clear from the outset

25 *For the importance that choice of governing law and forum plays see Governing Law Risks in International Business Transactions, by Philip Wood, Oxford University Press, December 2022.*

26 *On the "local law advantage", see Buchheit, Lee C. and Gulati, Mitu, Use of the Local Law Advantage in the Restructuring of European Sovereign Bonds (April 17, 2018). University of Bologna Law Review, available at SSRN:* https://ssrn.com/abstract=3159665 *or* http://dx.doi.org/10.2139/ssrn.3159665 *and Manuelides, Yannis, Using the Local Law Advantage in Today's Eurozone (June 17, 2019) available at SSRN:* https://ssrn.com/abstract=3405422 *or* http://dx.doi.org/10.2139/ssrn.3405422 *and at Capital Markets Law Journal, Volume 14, Issue 4, October 2019, Pages 469–487,* https://doi.org/10.1093/cmlj/kmz021

how and in what circumstances the sovereign debtor can use its "local law advantage" to effect changes in the terms of the instrument consistent with the legitimate expectations of investors.

2.8 Waiver of Immunity Provisions.

(a) In most commercial agreements including debt instruments, a choice of external governing law and forum/tribunal is always coupled with contractual waivers of the sovereign's immunity from:

(i) jurisdiction to hear disputes (immunity from suit);

(ii) jurisdiction to recognise judgments/awards (recognition immunity); and

(iii) enforcement/execution of judgments, (enforcement immunity).

(b) Immunity is a complex matter which Officials should consider in the context of:

(i) their choice of an external law/tribunal in relation to debt instrument;

(ii) the location of any assets the sovereign has or may have at the time of a dispute; and

(iii) the domestic immunity laws relating to suit, recognition, and enforcement.

(c) As the matter is complex and constantly evolving, Officials should regularly review it with the assistance of legal counsel.

(d) For the purposes of this handbook it is assumed that where the external law/tribunal is either English or New York law/courts, the immunity waivers requested of the sovereign will be comprehensive and, if correctly drafted, will cover in advance all three immunities (suit, recognition and enforcement) in relation to disputes under the relevant debt instrument.[27] Where the chosen external law/tribunal is not English or New York, Officials should take specific advice, as the corresponding immunity provisions may be more favourable to the sovereign. In particular, some jurisdictions will not give effect to a contractual agreement to waive all three immunities in advance. These jurisdictions are likely to recognise the contractual waiver as sufficient to waive the immunity from suit, and so will permit the hearing before their courts. However, they may require that a fresh waiver be granted in relation to a suit for recognition and a further fresh waiver be granted in relation to enforcement of a judgment.

2.9 Changes to the documents – the Amendments and Waivers Provisions

(a) When considering any new debt arrangement and the debt instrument documenting it, it is important to consider how easy it is to amend them and to obtain waivers in respect of obligations it imposes on the sovereign. This consideration has two aspects.

(b) The first aspect concerns the structure of the debt arrangement itself. Does it have a structure that can easily be amended? Are there any parts of the structure which are impossible to amend and if so, do they matter? How easy is the process for amending anything? Do any costs arise as a result of some amendments?

(c) The second aspect concerns the process for amending and granting waivers over provisions of the debt instrument. Does the debt instrument have provisions which allow the creditors to decide collectively and efficiently on appropriate majority bases (simple for ordinary matters, enhanced for extraordinary/"reserved" matters)? Are decisions binding on everyone? Are there any matters which are completely reserved to the discretion of each creditor? If so, how material are they and can they be used by a creditor in the future to "hold out" and refuse to go along with the decisions of the relevant majority creditors? If there are any such collective decision-making provisions binding minorities, is it possible or desirable to scale up this collective decision-making process across similar debt instruments?

27 *Based on the laws of England and New York as at the date of this handbook.*

2.10 Parties – creditors/investors

(a) .[28] The most challenging of all problems that Officials face is probably the identity of the creditors and the overall universe of available investors for a particular sovereign.

(b) On the one hand, a broader range of potential investors/creditors is likely to increase the available financing options and improve the cost of the debt. Indeed, a sovereign's investor relations outreach should be broad, inclusive and partially focussed on new types of investors who are likely to be "return players"[29] and be interested in being investors for the long-term.

(c) On the other hand, an increased diversity of creditor type exacerbates the collective action problem when a sovereign finds itself in distress. Each separate pool of creditor type will have to be both capable and incentivized to participate in a collective process, first within its own creditor pool and then within the wider group of the sovereign's creditors.

(d) Officials should consider all the questions listed in 4.4 above (*Contribution to GDP growth/other strategic goals*) as well as others like the following:

(i) Are these new investors, or are they existing creditors, now investing through a new instrument? If these are new investors, is it worth reaching out to them or will it take a lot more time, effort, cost and regulatory hurdles to maintain them as investors - are they more of a burden than a benefit?

(ii) If these are existing investors, are we cannibalising/fragmenting an existing investor group or are we enhancing it? Even if we are fragmenting it, does this increase the scope for raising debt or not?

(iii) Does the fragmentation result in an increase or a decrease of the collective action problem? This is a complex question and to begin answering it Officials have to consider further questions like the following:

(A) Are the new investors likely to be more, or less, cooperative than existing creditors? Are they likely to be disruptive if something unforeseen is requested by the sovereign debtor?

(B) In respect of each creditor type and for each set of creditors in a debt instrument:

I. how easy is it for these investors to absorb losses in case of a debt distress?; and

II. what is their funding cost and how might it vary (x) during the life of the debt arrangement and (y) if the funding arrangements have to be rescheduled?

(iv) At any time:

(A) How large is any specific creditor by (A) type, (B) amount of exposure, and (C) special gravity?

(B) How does each creditor's percentage participation in the overall creditor composition assist or impedes a major reset of financial arrangements?

(v) The identity and the identification of creditors party to a debt instrument is always an important matter. Does it matter if they cannot all be identified? Where there is a record of creditors, are the ones on the record the ones who take the decisions? With whom do Officials negotiate if they want to propose an amendment to the debt instrument's terms or seek a waiver in respect of some of the obligations it imposes on the sovereign? Is it possible, notwithstanding the inability to identify all creditors, to reach a decision based on the process prescribed in the debt instrument?

28 *The terms "creditors" and "investors" are used almost interchangeably in this section. Strictly speaking "investors" are all the potential creditors of the sovereign whereas "creditors" are the ones actually lending to it at the relevant time.*

29 *The phrase is used to describe investors who are interested in continuous participation as investors in a particular market and, unlike "one-off players" have an interest in the long-term flourishing of that market.*

This is an analysis that Officials must do whenever they enter into a new debt instrument. It is possible that not all creditors can be identified, as in financings involving listed instruments such as bonds. It is equally possible that the creditors on the record, parties to the debt instrument, may not be the real creditors providing the credit or assuming the risks and rewards of the debt, as is the case in loans with sub-participants, whether they support the funding and the credit of the loan through funding deposits or just the credit through guarantees. The decisive questions each time will be:

(A) is there a way to negotiate, even through intermediaries, representatives or with representative groups?; and

(B) is there a process which is capable of resulting in a decision binding on all relevant creditors?

(vi) Officials should consider the Party Identity and Changes Provisions in the context of:

(A) each specific debt instrument;

(B) overall investor relations management; and

(C) both ordinary times and times of debt distress.

(vii) The Party Identity and Changes Provisions in the debt instrument are important in the determination of the identity and the identification of creditors party to a debt instrument. More specifically, Officials should consider the following:

(A) What exactly do these Party Identity and Changes Provisions permit?

(B) Who can become a new creditor in place or alongside an existing creditor?

(C) Is it legitimate and appropriate for the debtor to want to control this process? Are there any legitimate limitations to the control of this process?

(D) Who bears the credit and funding risk? The lenders of record or a host of sub-participants? If the latter:

I. how transparent are the credit support arrangements?

II. how easily can the sovereign engage with these sub-participants?

2.11 Parties – debtors/obligors

(e) Guarantees and equivalent support provided by, or to, the sovereign is not novel, in the sense that they are well-known and simple arrangements. However, they almost always back up something which does have an unusual feature, namely the perceived inability of another person's primary debt obligations (the **Primary Obligor**) to meet its obligations on a standalone basis. The circumstances can vary. If the debt instrument has obligors besides the sovereign, the two most likely candidates are likely to be (x) the central bank as guarantor of the sovereign's primary debt obligations or (y) the sovereign itself as guarantor of the Primary Obligor. Primary Obligors are most likely to be state owned enterprises (**SOEs**) or special purpose entities (**SPEs**) undertaking a specific project.

(f) Officials should consider questions like:

(i) What is the purpose of the guarantee? Is there a genuine reason to provide support? How likely is it that the guarantee will be called?

(ii) How will the guarantee be reported in the public accounts? What reserves is it prudent to make and for what percentage of the exposure?

(iii) Is it appropriate to have the central bank guarantee the sovereign's debt? Bank loan financing in the 1970s was to the central bank with the guarantee of the sovereign, a practice that changed with the shift to the capital markets, where the only obligor was the sovereign bond issuer. Central banks have a distinct legal personality because they manage the reserves of the sovereign and because these reserves are intended to be kept out of the reach of the sovereign's creditors. Creditors have in the past claimed that central banks were the *alter ego* of the sovereign and that immunity waivers by the sovereign extended to their central banks and their assets. These claims have on the whole failed.[30] Bringing in the central bank as a guarantor is a major step change that should be considered very carefully.

(iv) Is it appropriate to have the sovereign guarantee the central bank's debt? Usually this will happen if the central bank has borrowed directly to boost its reserves. This borrowing is usually done either through direct lending facilities in the relevant foreign exchange currency or through swaps which allow the recipient central bank to use the resources of the lending central bank. These facilities and swaps have been used extensively during crisis periods to alleviate temporary liquidity problems. "Temporary liquidity problems" is the key here. How lending and borrowing central banks determine that the problem is just one of liquidity, what collateral they take in securities held by the borrowing central bank and how and when these arrangements are unwound/repaid can be a complex matter. For the time being, these arrangements remain outside the scope of sovereign restructurings, and so, beyond the references in the footnote, will not be further discussed in this handbook.[31]

(v) Is it appropriate to take on the debt of an SOE/SPE? Is the debt that the SOE/SPE takes on not capable of generating sufficient revenues to service it and also generate additional returns? Should the guarantee be provided on condition that the financial structure does generate sufficient revenues and if so during what timeframe? Are the revenues to be generated from the SOE/SPE projects sufficient to cover debt service of the underlying debt or will the sovereign have to inject funds to the SOE/SPE for this purpose – and if so, how will this be funded and how will it be accounted?

2.12 Secured finance[32].

(g) Granting security in connection with any sovereign financing means that one is already in the territory of "non-traditional debt". Secured finance is considered in more detail in Schedule 1 below. Secure finance is non-traditional not because sovereigns do not enter into such transactions, or because all such transactions are somehow problematic. It is non-traditional because, traditionally, almost all of sovereign debt, both by amount and debt instrument type, is unsecured.

(h) Secured finance can be a great benefit because it can provide finance in more advantageous terms. However, secured finance can also be the source of a number of problems which may impede economic development, create an uneven playing field among creditors, obscure the state of public finances and state assets and disguise the true economic health of the sovereign borrower. Officials must therefore scrutinise any debt instrument which requires the giving of a sovereign asset as security for the liabilities of the sovereign debtor. When faced with proposals for sovereign financings, Officials, should be asking questions like the following.

(i) Is the proposed secured financing the sole option for accessing the markets? Does it commit the sovereign to a narrow investor base? Is the financing part of a long-term strategy of economic growth, diversification and ultimate access to a broader investor audience on an unsecured basis?

(ii) Will the proposed security interest be public/publicly registered? Will other creditors be capable of knowing about it?

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30 *For a discussion of these topics see Philip Wood, Principles of International Insolvency (2nd edition, Sweet & Maxwell 2007) sections 25-020 and 25-030.*

31 *See US Federal Reserve "Credit and Liquidity Programs and the Balance Sheet" (here); ECB "What are currency swap lines?", (here); IMF "Use of Foreign Exchange Swaps by Central Banks" (here); BIS "Central bank swaps then and now: swaps and dollar liquidity in the 1960s" (here). For a discussion of the uses of these swaps during the pandemic see The Economist "The successes of the Fed's dollar-swap lines" (here) and an interview of Brad Setser "Addressing the Global Dollar Shortage and COVID-19's Implications for Worldwide Trade Imbalances" (here).*

32 *Also referred to as "collateralised finance" and "security as "collateral".*

(iii) Will its accounting treatment be such so as to reflect the state of the sovereign's assets and liabilities over time and not inflate unduly current assets and leave future liabilities uncovered?

(iv) More generally, how is the transaction to be recorded, reported and accounted for? What will be its effect on debt management and sustainability?

(v) Is the proposed security provided:

(A) to give the secured creditor a super-priority in times of debt distress and so provide an advantage to that creditor over the others?

(B) to protect the ability of a project to be completed within the parameters of the initial legitimate expectations of both the creditors and the debtor?

(C) as an incentive to all creditors of a certain class to accept it at their option, in return for finding a way out of an impasse in a collective restructuring?

(vi) What is the nature and function of the asset requested to be given as security?

(vii) More narrowly, are the proposed security arrangements consistent with the terms of the sovereign's other debt instruments? Do they:

(A) breach any obligations to other creditors under (I) Negative Pledge Covenants granted to other creditors or (II) unusually drafted *pari passu* representations and undertakings?

(B) Do they commit the sovereign to extend the security arrangements to any other group of creditors?

(viii) More broadly, how will other creditors react to knowing about security arrangements which do not benefit them? Will this distance any other group of creditors narrowing the investor base of the sovereign? Will this cause a rift between creditors which may be disadvantageous during times when the consent of all creditors is needed?

2.13 Provisions enhancing "fragility" – Cross-Defaults and Status Defaults.

(i) Officials need to devote attention to debt instruments that include Default Provisions including Cross-Default and Status Default provisions (see 3(c)(v) above). They are the means through which creditors in different and disparate debt instruments with the same debtor establish a virtual community which binds and brings them together. Even though they may not know each other, the level at which these provisions are set in their relevant debt instruments indicates in what creditor community they wish to belong and at what point in time. For example, and at one extreme end, a creditor may request a cross-default on the non-payment of any amount or the non-compliance of anything under any other debt instrument of the debtor. At the other end a creditor may agree to limit the cross-default to breaches under debt instruments of the same type and only if the other set of creditors have in fact taken steps to terminate the relevant debt arrangements. The former set of provisions increase the overall fragility of the debtor's debt arrangements: all of them are as vulnerable as the most vulnerable one. The latter introduces a balance and resilience which may be needed to allow the debtor to address a specific vulnerability and avert a more generalised distress situation. The same comment applies to Status Defaults.

(j) So, Officials should be looking very carefully into the proposed Cross Default and Status Default provisions in any new debt instrument:

(i) Do they increase the overall fragility of their debt arrangements or bolster their resilience?

(ii) Do they allow the debtor a legitimate elbow room to sort out specific challenges, or do they force it too early and unnecessarily to face an overall debt restructuring?

(iii) Do they allow the creditors to assemble their virtual community too early and collectively face the debtor, or do they allow the debtor to bring this virtual community to the table at the right time when a discussion with all creditors is of the essence?

2.14 Provisions ensuring intercreditor equity.

(k) Officials must consider issues of intercreditor equity and fair treatment as part of their overall investor relations outreach, both current and prospective. Whereas each financial arrangement is made with creditors representing a subset of the sovereign's actual and potential investors, Official should keep an eye on the way they treat each such group of investors by reference to other creditor groups.

(l) The long-term credibility and commitment of the sovereign debtor is enhanced by fair and equitable dealing with all creditors, in return always for terms advantageous to it. Officials should aim to cultivate a broad universe of potential investors, all of whom are "return players" and all of whom have an interest in preserving a long-term and symbiotic relationship with the sovereign[33]. Debt instruments should include provisions which make this task easier, or, at least, not more difficult.

(m) In addition, the special nature of sovereigns as debtors[34] and the need to resolve any eventual crises by consent, means that the sovereign has every interest to include provisions in its debt instruments which do not undermine the equitable treatment of creditors in the future.

(n) Previous sections have considered the types of questions that Officials should ask in respect of the identity of their creditors, the way creditors decide collectively binding minorities, the potential creditor divisions that security in favour of some can create, and the way that creditors themselves try to establish a common group in extreme cases. Officials should in addition consider the following questions when agreeing to the provisions of any new debt arrangements.

(i) Do the Covenants Provisions allow the relevant creditors a right or a benefit which is material, is not justified by the unique financing structure of the debt arrangements and would be something which most other of the sovereign's creditors would be interested in having? In other words, is there some sort of benefit conferred on these creditors which can be said to be an unfair preference?

(ii) Are the Information Covenants included in the Covenants Provisions of the various debt instruments consistent and do they convey to the relevant creditors the same information and the same range of information?

(iii) Do the Information Covenants as drafted across debt instruments expose the sovereign to a breach of any applicable market abuse laws[35] and/or place any investor at risk in respect of its publicly traded debt instrument for possession of "material non-public information[36]"?

(iv) Should the information supplied under the Information Covenants be publicly available or is there a legitimate reason to keep any parts of it confidential?

(v) Are the Confidentiality Provisions consistent with the Information Covenants? Do they unreasonably and for no legitimate reason constrain the sovereign from sharing information with international bodies of which it is a member (e.g., the IMF), or with other creditors?

(vi) Do the various Negative Pledge Covenants and any permitted security interests maintain a balance of equity among creditors given their corresponding legitimate expectations?

(vii) On the whole, is there anything in the provisions of the debt instrument which could be used as excuse for creditors not-participating in any future crisis resolution which requires participation and co-operation?

2.15 Provisions enabling orderly

33 *See also the discussion in 2.5(g) above.*

34 *See 2.5 and in particular 2.5(e) above.*

35 *For the EU's market abuse regulation see here.*

36 *For a definition of MNPI, Material non-public information, see the Investopedia entry here.*

management

(o) Finally, Officials should ask whether the other Administrative Provisions in the proposed debt instrument are consistent with the sovereign debtor's equivalent processes and commitments in its other debt instruments (see also comment made in 4.2(d) above).

2.16 Not everything can be anticipated – keep questioning!

(p) It is important to remember that sometime crises reveal wider problems about the overall sovereign debt architecture as it stands at a particular time. The "lost decade" resulted because of the unfortunate combination of two things. First, the Bretton Woods system where world currencies were pegged to the US dollar and the US dollar to gold had collapsed. With it came a much higher US inflation and an overall fluctuation in interest rates which had not been anticipated. The US Dollar bank loans which formed the bulk of the debt of the Latin American sovereign debtors (and others elsewhere) had a floating margin which rose as US interest rates rose. The debt became unsustainable. Second, the lenders had not prepared for the possibility that they would suffer losses and hence could not accommodate them without facing some sort of sever distress themselves.[37] There is usually little that Officials can do in anticipation of such systemic crises and hence little that can be said in this handbook to address directly such systemic market disruptions. What Officials can and should do is to keep on raising the questions identified in this handbook and building an overall resilient set of sustainable debt arrangements.

37 *See 1.2(a) above including the optimistic assertion of William Wriston quoted there.*

3. NEXT SECTIONS – LOOKING AT CERTAIN TYPES OF NON-TRADITIONAL DEBT

(a) The next sections of this handbook, set out as "Schedules", will discuss certain types of non-traditional debt. There will not be a comprehensive presentation of all terms of the non-traditional debt instruments under discussion. The purpose of the discussion will be to illustrate issues that arise out of the principles and features considered in the previous sections and, where possible, identify provisions where attention can lead to more optimal outcomes.

(b) As discussed earlier[38], the term "non-traditional debt" is used to refer to debt provided either in novel ways or in established ways but by new creditors. The sections that follow will cover:

(i) old types of debt whose structures are always either novel or present novel challenges like secured finance, project finance and;

(ii) new types of debt:

(A) Islamic capital market debt instruments;

(B) commodity-backed finance; and

(C) securitisations and discounting of receivables;

(iii) loans since their inherent flexibility allows them always to reshape into something new; and

(iv) a consideration of "plurilaterals".

(c) Two new types of non-traditional debt, debt for nature swaps and debt contingent on the occurrence of various acts of God, particularly climate resilient debt instruments will not be discussed in this handbook. They are specifically considered in **the ALSF Debt Guide on Debt Swaps** and the **ALSF Debt Guide on State Contingent Debt Instruments**.

38 *See 1.1(c) above.*

CHAPTER TWO

SECURED FINANCE – PROJECT, COMMODITY-BACKED, AND RECEIVABLES FINANCING

1. WHY IS SECURED FINANCE "NON-TRADITIONAL".

(a) Secured finance is included as "non-traditional" finance because, traditionally, almost all of sovereign debt, both by amount and debt instrument type, is unsecured.

(b) Nonetheless, a number of sovereigns do use secured debt. The motivations are varied. In some instances, particularly with project finance and risk sharing on projects with the private sector, it will be to mobilise private resources for infrastructure and energy and to share risks with the private sector (broadly "**project finance**").

(c) Enabling early market access and a lower funding cost are two additional reasons. Such secured debt is likely to be available to sovereigns whose economies may be less developed (making unsecured debt from private sources more expensive) but are rich in natural resources. These sovereigns will raise debt either (i) secured by these natural resources (and/or their sale proceeds) or (ii) by making these resources (and/or their sale proceeds) available solely to the relevant creditor (broadly "**commodity-backed finance**"). Other sovereigns will raise funds by isolating a stream of high-quality future receivables and either (i) sell them or (ii) make them available solely to the relevant creditor(s) (broadly "**receivables financing**" or "**future flow financing**" and together with commodity-backed finance referred to as "**collateralised debt**").

(d) The financing structures which can be used to raise secured finance are varied and always evolving, showing a design flexibility which is constrained only by the secured asset in question (project, resource/commodity or receivable), and the ways and places in which they or debt instruments backed by them can be traded. The corresponding typologies and law that have developed to address the relevant issues are many and large.[39]

2. THE ISSUES RAISED BY SOVEREIGN SECURED DEBT.[40]

(a) The full set of issues raised by sovereign secured debt is discussed in a joint IMF

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39 *The law of security interests is vast and complex. For an overall global view of security interests around the world and how they operate see Philip Wood, Comparative Law of Security Interests and Title Finance (volume 2 of Law and Practice of International Finance), Second Edition, Sweet & Maxwell, London 2007.*

40 *The full set of issues raised by sovereign secured debt is discussed in a joint IMF and World Bank paper - Collateralized Transactions: Key Considerations for Public Lenders and Borrowers, 19 February 2020, available here. Officials are urged to read it as it presents a comprehensive consideration of two of the cornerstone institutions in the current*

and World Bank paper - *Collateralized Transactions: Key Considerations for Public Lenders and Borrowers*, 19 February 2020, available here. Officials are urged to read it as it presents a comprehensive consideration of two of the cornerstone institutions in the current economic world order on the matter. It highlights a number of important considerations for both creditors and debtor countries. Some of these considerations are also discussed here, but the scope of the IMF/WB paper is more extensive.

(b) Secured finance operates by giving priority to the secured creditor and subordinating the remaining creditors since the sovereign has access to a reduced pool of assets. This generates a structural imbalance between types of creditors. At a time of crisis this means that most of the burden will be placed on the unsecured creditors, the general economy and the weakest within the country. This is the case particularly, if not exclusively, the case in the case of collateralised debt where the best assets (commodities and receivables) will not be available to the sovereign for distribution but will be committed to the secured creditors.

(c) The structural imbalance may also adversely affect the future raising of unsecured debt. Unless the sovereign can use the window of cheap financing to grow and diversify its economy, it may find itself committed to a narrow funding policy of collateralised financing with a very small group of investors. The inability to sign-up to Negative Pledge Covenants of other creditors (particularly the World Bank negative pledge)[41] may in itself prove a constraint.

(d) Collateralised financing, especially one which relies on non-publicly disclosed structures, runs a number of misreporting risks.

(i) The borrowing may not be directly linked with the granting of the asset as security. This may lead to an overstatement of assets available in the future.

(ii) The capital amount raised by the transaction may not be properly recorded as "debt", a risk inherent in any collateralised transaction which is structured as a forward sale of assets/receivables. This will understate the liabilities and may lead to gaps in the debt management.

(iii) Incomplete or incorrect reporting may be internal or external. An incomplete or incorrect internal reporting will result in an incomplete or incorrect external reporting. Accurate and complete external reporting:

(A) is required by the IMF of its members in the ordinary course of events under Article VIII Section 5;[42]

(B) will very likely be required by the IMF in a detailed manner if the sovereign requests any IMF assistance;[43]

(C) will be requested by prospective unsecured creditors in the context of their Negative Pledge Covenant due diligence;

(D) will be requested by creditors generally in cases of debt distress and need for restructuring; and

(E) is likely to be required under the sovereign's own transparency policies or requested as part of its government internal accountability laws and regulations.

(e) All these issues are multiplied and complicated when the collateralised debt transaction is entered into by an SOE and the sovereign is asked to guarantee the transaction. This is a real risk given that commodities and other types of resources are very likely to be owned and/or managed by separate commercial entities established by the sovereign for the purpose.

economic world order on the matter. It highlights a number of important considerations for both creditors and debtor countries. Some of these considerations are also discussed here, but the scope of the IMF/WB paper is more extensive.

41 *See Chapter Two, Part 4 4.4 (A special type of covenant – the World Bank Negative Pledge Covenant).*

42 *See IMF Articles of Agreement, Article VIII, Section 5, here.*

43 *See note 19 in IMF's paper Making Public Debt Public, 31 July 2023, here, citing that the Angola and Ecuador IMF programs contained as a "prior action" specific disclosure of their collateralised debt arrangements.*

3. WHY IS ALMOST ALL SOVEREIGN DEBT UNSECURED?

There are a number of reasons for this.

(a) First, there is something inimical in a sovereign granting security over its assets. A sovereign is first of all sovereign over its own assets – it can sell them or grant licences over them, but equally, to the extent they are within its jurisdiction, it can take them back or just tax them, subject to limitations that it has chosen to impose on itself.[44]

(b) This position is in essence reflected in the law on state/sovereign immunity. Assets within a sovereign's jurisdictions are ultimately subject to its laws (subject to the self-imposed limitations mentioned above). Assets in the name of the sovereign itself (as opposed to its central bank) outside its jurisdiction tend to be few and only present there for short times. They are also at first instance protected by the state immunity doctrines of the host jurisdiction. Immunity can of course be waived effectively in respect of some assets resident in some jurisdictions and so it is possible to establish secured financing structures.

(c) In practical terms, for security to be meaningful to a creditor who wants to achieve priority over others, the assets have to be located outside the debtor's jurisdiction in a place where the debt claim can be recognised, it and the security can be enforced, and the security be capable of being easily liquidated. Providing security which satisfies these conditions and is available in material amounts will not be easy for most sovereigns, making the option of secured finance a limited one.

(d) Unsecured creditors seek to protect themselves with provisions ensuring equal ranking of creditors (the *pari passu* clause) and the Negative Pledge Covenant by the sovereign debtor not to encumber its assets. Prospective unsecured investors will not invest if they are asked to be structurally subordinated.

(e) Investors on the whole know of these limitations and of what makes sovereigns unique.[45] These investors prefer to lend on an unsecured basis and then face any challenging times from the same basis. They understand that:

(i) secured finance structures are structurally complex, cannot be scaled easily and are illiquid;

(ii) sovereign immunity always lurks to undermine enforcement;

(iii) ultimately the assets available as effective security capable of being enforced are limited;

(iv) in the case where the security is a commodity or other natural resource, the status of their debt depends not on the economic performance and growth of the country but on the market value of the commodity or other natural resource which acts as security; and

(v) as a result, there is an economic growth limit to a sovereign debtor relying almost exclusively on collateralised debt. This makes the viability of any debt arrangements with the sovereign riskier and more fragile as this growth limit is reached.

4. STYLISED SECURED FINANCE ARRANGEMENTS.

(a) To understand better the points made so far, we now turn to consider certain secured finance arrangements. These will be described in stylised form abstracting from their overall technical and documentary complexity. Stylisation will allow us to focus on structural features of the arrangements. These features need to be reviewed and assessed by Officials. The technical and documentary complexity will evolve and will always require

44 *These limitations may range from constitutional protections of the right to property and fair compensation for expropriation up to international treaty agreements to protect and compensate the same.*

45 *See 2 in main section above.*

the assistance of expert financial and legal advisors.

SECURED FINANCE – PROJECT FINANCE

1. WHAT IS PROJECT FINANCE?[46]

(a) Project finance at its simplest is what it says: the financing of a project. The **project** may be a tunnel, bridge or highway; an oil and gas field; a mine; a mobile telephone or cable network; a refinery, power station or pipeline; or offices or shops, or any other venture involving construction or engineering. Such projects are vital for the economic development of sovereigns. This makes them very interested in seeing them built, operated, maintained and of course used.

(b) Who determines what projects should be built, how they will be funded and then operated & maintained, will depend on each country's level of economic development and its political economy institutions. In many sovereigns the initiative and/or the decision to proceed will rest with the government and/or SOEs and this is the working assumption of the present discussion.

(c) How the project is executed and funded has a range of answers. At the one end, the sovereign or the SOE decides to hire designers and contractors to design and build the project and then raise funds to finance this. In most of these cases the funding comes from banks specialising in long-term development finance, sometimes through a syndicate which may include multilateral banks (e.g., the African Development Bank, one of the World Bank affiliates), official bilateral lenders (or insurers backing commercial banks) and commercial banks, both international and domestic. In these cases, the credit risk rests with the sovereign or the SOE (or both if the sovereign is asked to guarantee the SOE) and the repayment is assumed by the sovereign, as one of its own direct obligations, or the SOE to the extent it can pay the debt service. The assumptions and expectations are that (i) the economic benefits of the project will accrue to the sovereign's economy (whether regionally or as a whole), and (ii) the increased economic activity will generate revenues for the state or the SOE which in turn will permit it to service the project debt. For example, a motorway or a railway may provide the transport infrastructure which brings in a geographically remote part of the country and so enables its economic growth through ease of transport of goods and people. This in turn will increase economic activities and the sovereign will collect a share of it through any number of taxes or duties. A new electricity generation plant built and operated by the energy SOE may provide enhanced energy supplies to a region and so benefit consumers and enable industry and manufacturing to develop. Users will in turn pay the SOE for the electricity consumption. The simple concept is that infrastructure and energy projects will increase the sovereign's GDP, and this will permit the sovereign and its SOEs to service their project debt.

(d) This first type of project debt is usually not secured at all. The reason is that a security interest on a motorway or the energy plant

46 *To guide you through the topic see Project Finance: A Legal Guide, 4th Edition, by Graham Vinter, Gareth Price, David Lee, Sweet & Maxwell, August 2014 (also available electronically through Practical Law, here) and Project Finance, Securitisations and Subordinated Debt (being volume 7 of Law and Practice of International Finance), by Philip Wood, Third Edition, Sweet & Maxwell, London 2019. See also the World Bank webpage Public-Private Partnership Legal Resource Center, here, which contains a wealth of useful references. See also the entry in the World Bank blog, Strong PPP legal frameworks are fundamental & new guidance helps countries build them, by Tim Conduit and Fleur Clegg, here, which launched the Guidance on PPP Legal Frameworks 2022, produced for the World Bank by Allen & Overy, here.*

does not necessarily ensure that there will be sufficient revenue generation to repay the debt. This would require a higher degree of involvement in all the stages of the project, from procurement, design and construction, to operation, maintenance and revenue collection. In these projects it is the sovereign (or SOE) itself who assumes the responsibility and risk for the successful implementation of all these stages.

(e) Sovereigns can and do spread the responsibility and risk of projects by bringing in private parties who are interested in sponsoring the particular project.[47] Here the bulk of the financing is provided principally by debt and is repaid out of revenues produced by the specific project. The project sponsors receive a return out of the construction, operation and maintenance of the project. The sponsors return is periodic and not upfront, making them have an interest in the long-term good performance of the project. The return is always conditional upon meeting certain minimum key performance indicators, ensuring that the sovereign's interests in this project are met.

(f) These projects are structured in ways which aim to generate predictable cash-flows over the long term. These cash-flows should be sufficient to repay the debt and the interest on it and to give the sponsors a fair return. A simplified structure for such a project finance is the following. The sovereign enters into the project agreement with the project company, a special purpose company established and owned by the project sponsors. The project agreement (i) gives the project company the right to design, build, operate and maintain a project e.g., a motorway on the basis of certain basic specifications and (ii) allows the project company to charge specified tolls for the use of the motorway, all within certain pre-defined parameters. The project company engages appropriate contractors for the design and construction of the motorway and with its operation and maintenance. The sponsors are also responsible for raising the finance for the project, which, as noted earlier, is principally debt finance and is provided by the same range of creditors mentioned in (c) above.

(g) In order to finance the project, the creditors want predictability and sufficiency of the overall project cash-flows. Their willingness to provide finance depends on assessing the risks of the project, its "bankability", as determined by the creditors. Bankability will depend on the project structure and market practice, making it a fluid concept. As a general rule, creditors will not accept risks which are either incapable of proper assessment or analysis, or which are potentially open-ended in their effect. They will for example accept traffic risk, but not change of law risk.

(h) "Bankability" viewed narrowly is a concern of the creditors. Viewed more broadly it is also a concern of the sovereign/SOE. Bankability considerations help make a project a success, whether they are applied by the creditors or not. In a more "structured" project, bankability concerns are brought in by the creditors because they are asked to assume a set of risks. In an "unstructured" project, the same risks exist, but in fact a lot more of them are assumed by the sovereign/SOE. In an "unstructured" project the sovereign should consider the bankability concerns and considerations they raise by putting itself in the shoes of the creditors as if the project were "structured".

(i) Broadly bankability requires assurances on the following:

   (i) Risks which depend on the sovereign such as change of law risk which overturns the fundamentals and the financials of the project arrangement, discriminatory taxation affecting adversely the project's cash-flows, capital and exchange controls introducing currency risks not capable of being managed in advance, expropriation or termination of the project agreement. These are usually addressed with compensation provisions by the sovereign in the project agreement.

47 *In the rest of this section as we consider a secured project finance arrangement, we will focus only on infrastructure projects. Secured project finance is of course widely used for other projects. These are discussed in the references mentioned in note 47 above.*

(ii) Certainty that if there is ever a termination of the project, the lenders will receive a pre-agreed termination compensation – usually their outstanding principal amount and unpaid interest. Again, this is an assurance provided by the sovereign.

(iii) Direct agreements with the sovereign and the third-party contractors for continuity of arrangements in case the project company fails and the lenders try to maintain the project. This is something which is dealt with contractually with the parties including the sovereign.

(iv) The project design is the appropriate one for a viable economic return, the construction costs are certain, the construction will be completed by certain day, costs for delays are appropriately shared and covered in a creditworthy way, construction warranties are provided, and a maintenance programme is put in place with its funding secured. More generally, certainty on construction costs and overall cash-flows which are appropriately modelled and include management of currency risks. The modelling is done by the project company and approved by the creditors on the basis of the risks that they have identified.

(v) Appropriate payments "waterfall". This sets the priority for the allocation of gross revenues. It usually starts by ensuring payment for the basic functions of the project (e.g., payment of agreed construction and operating costs, payment of administrative parties etc.), the funding of reserve accounts (e.g., a debt-service reserve account to keep the debt current against temporary drops of project revenues, accounts for other contingencies and for maintenance etc.), the repayment of debt and, lastly, distributions of any surpluses to the sponsors.

(vi) Project cash-flow expectations set at realistic levels. This allows the project financing structure to survive even on a "down-side" case, when some of the fundamental assumptions underlying the model prove to have been optimistic. The loan documentation in project financing will include a range of appropriate financial covenants and "cover ratios". These monitor the financial performance of the project, determine the distribution of the gross revenues among the various project stakeholders and provide early warnings of distress.[48]

(vii) Legal and contractual certainty. This means enforceability of the project agreement, prevalence of it over conflicting laws and, most importantly for our topic, effective defensive security.

(j) Project cash-flows are modelled and the bankability requirements of the creditors require that the cash-flow requirements be set at realistic levels. This allows the project financing structure to survive even on a "down-side" case, when some of the fundamental assumptions underlying the model prove to have been optimistic.

(k) All of the security is provided by the project company: security interests over all its contracts, its accounts (operating and reserve accounts) and its receivables. Crucially this includes a security interest over the project agreement, which means that the sovereign will have to make payments directly to the creditors if the security is enforced. The important point to note is that in such a project finance structure, the sovereign does not itself grant any security over any of its assets. The sovereign retains exposure on the project, but all of its exposure is unsecured. At most, the sovereign exposure is an indirect guarantee of the debt (through the compensation payable to the project company which is assigned by way of security), but this guarantee is itself unsecured.

(l) Not only is the exposure of the sovereign unsecured, but the security granted in fact

48 *Financial covenants and "cover ratios" are the most important part of Cash-Flow Provisions in project financing. These covenants are complex, their detailed drafting will always depend on the particularities of the project. As their discussion falls outside the scope of this handbook readers are encouraged to learn more about them by reviewing Chapter 9 "Ratios and Accounts" of Project Finance: A Legal Guide, 4th Edition, referred to in footnote 47 above.*

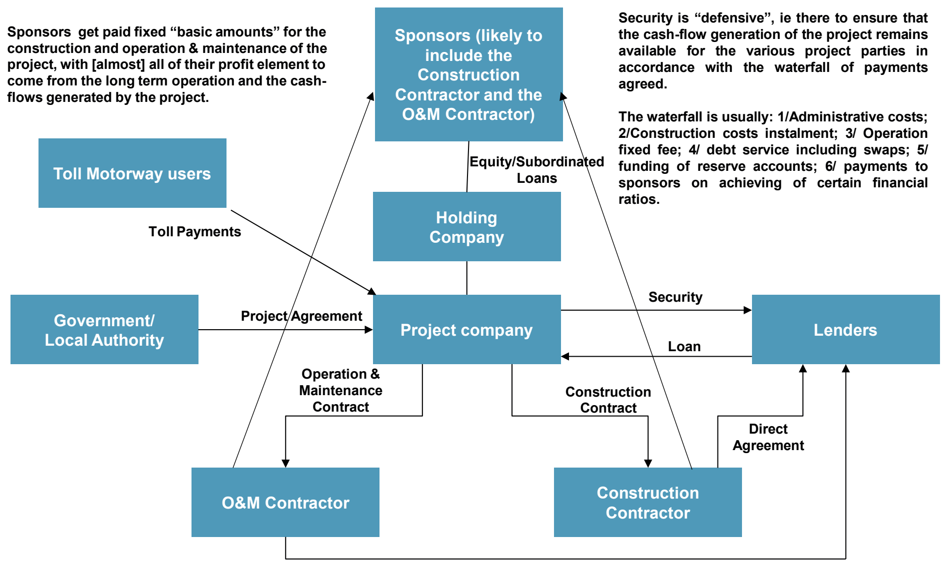
minimises any potential exposure of the sovereign, since it seeks to give priority to the creditors over all receivables of the project company, receivables which serve to reduce the overall debt.

(m) Project finance can therefore refer to two different ways in which the project in question is financed. The first is the "unstructured" way, where the creditors simply lend to the sovereign or SOE to construct a "project", but otherwise leave the arrangements on the design, construction, operation and maintenance to the sovereign/SOE. This can happen even when the contractors who have offered to build the project for the sovereign/SOE bring along the creditors who will finance it. The second way is the "structured" way, where the sovereign/SOE, the sponsors/contractors and the creditors agree how to allocate risks and creditors impose their "bankability" requirements. Whether it is unstructured or structured, the success of the project will depend on overall risk allocation and bankability considerations.

(n) An ideally structured project has an appropriate risk allocation, is bankable and can provide for contingencies. It is positive for all concerned, first and foremost to the sovereign. It can deliver to the sovereign the needed and desired project which helps its economy to grow. The sovereign's financial commitment is contingent and the only support it needs to provide is that of legal certainty through the project agreement. Depending on the project, the sovereign may also retain for itself a part of the revenues. For projects with a defined period of exploitation (e.g., a motorway or an airport), the sovereign will also be looking to take possession of the project at the end of that period, and, assuming it has negotiated the "redelivery conditions"[49] correctly, it will own a well-maintained project of value.

(o) A project can also be less than ideally structured. A number of things can go wrong. When it goes wrong it is the sovereign who will have to face the difficulties. The project may prove to be uneconomic or not fit for the purpose and the sovereign may face unexpected financial demands. Proper preparation and advice from experts early on can mitigate the risks of things going wrong.

Simplified graph for Toll Motorway project



49 These are the provisions in the project agreement which prescribe the condition in which the project must be delivered to the sovereign at the end of its period of use under the project agreement. These provisions will address maintenance standards and cash-reserves to be made available to remedy any shortcomings.

SECURED FINANCE – COMMODITY-BACKED FINANCE

1. WHAT IS COMMODITY-BACKED FINANCE?

(a) Commodity-backed finance is simply a form of trade finance, itself one of the oldest and most widespread forms of finance. The fundamental idea is simple: a buyer wants to buy goods[50] from a willing seller. They need to find a way to ensure the goods can be delivered and the payment made without risk that either of these will fail. In many cases the transaction can be completed immediately with immediate and simultaneous delivery and payment. If the parties are in different countries or if the procurement/production of the goods requires time and/or money, or if the there is anything else which introduces a lag between the delivery and payment of the goods, then some form of transport, insurance, credit and security arrangements must be put in place to address the risks either of (i) payment and non-delivery, (ii) delivery and non-payment, (iii) appropriate transport and risk of damage or loss during the transport. The letter of credit in its various forms and uses is the simplest and most common instrument for trade with features and requirements which cover credit, means of payment, transport assurance, insurance and security.[51]

(b) Each type of good traded will also raise its own challenges. Selling a Picasso painting from a private collector in Europe to a museum in the US, raises very different challenges from the sale of crude oil from a landlocked country in Africa to the Far East markets. We will focus on the trade of commodities because these are the ones which some African countries have in abundance, they are much sought after in markets around the world and, for some sovereigns with less developed economies, they represent their principal source of revenue.

(c) Commodities are so called because of their economic use and their fungibility. They range from raw materials (e.g., mining products such as iron ore, oil, gas, diamonds) to basic agricultural products (e.g., wheat, sugar, rice) to mass-produced unspecialized products (e.g., chemicals and computer chips).

(d) All trade arrangements will seek to achieve the certainty that a simultaneous delivery and payment would achieve. The goal is fraught with challenges. Here are some examples focussing on commodities:

(i) the trade arrangements may range over long periods during which the pricing may fluctuate beyond limits envisaged in the original sale agreement and beyond what may be possible to be hedged in the markets;

(ii) the commodity may need funding to become available (e.g., it may require mining or cultivation) making some sort of advance financing necessary. This can be

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50 *Could also be of services, but for the purposes of our discussion we will only refer to goods, commodities being some of the most commonly traded goods.*

51 *For a general discussion of trade law and its basic tools see Goode on Commercial Law, edited and revised by Ewan McKendrick, Sixth Edition, February 2021, London. For documentation on some of the more complex transactions discussed here see the Loan Market Association's pages on Pre-Export Finance (here) and Export Finance (here). For further legal guidance see A Guide to Key Resources: Trade Finance in the online Practical Law of Thomson Reuters (here).*

raised by the seller or by an existing buyer, but in either case the financing will be a lot cheaper, and hence preferable, if it relies on security over the commodity. It is safe to say that there is virtually no trading of commodities which does not rely on a host of security interests as the commodity is produced/extracted, stored, shipped, sold and delivered;

(iii) the delivery of the commodity to actual or potential buyers may be across a number of countries and geographies and/or through common means of storage and/or transport. This makes the security arrangements a lot more complex since a number of different jurisdictions and transport means will be involved. The challenges increase when the storage or transport used also carries shipments of the same [fungible] commodity sold, bought or financed by different parties.

(e) Whereas trade involving commodities will be found wherever there is an abundance of them, commodity-backed financings in less economically developed sovereigns are likely to have some characteristics which make them unique. These are likely to include some or all of the following:

(i) The commodities are owned by the sovereign and/or its SOEs. Their export trade therefore represents a major source of revenue for the sovereign.

(ii) The selling part of the export trade is a concentrated one, because there is in essence only one seller, the government department or SOE responsible for this commodity.

(iii) The commodity is in abundance, but it requires capital to enable its extraction/growth, storage, domestic transportation etc.

(iv) The sovereign/SOE will be tempted to scale up the trade arrangements and seek to raise proceeds from the advance sale of the commodity to generate the required amounts for further capital investments for the production and trading of the commodity itself or other productive ends for the sovereign's economy. Scaling means that what is periodic (annual?) cycle of production and export sale of the commodity becomes a multi-annual arrangement.

(v) The two most commonly used structures to sell the commodities are the pre-export finance structure and the prepayment finance structure. They are complex structures with additional features on the basic arrangements of trade finance transactions to address the concerns of purchasers and their creditors that arise from the "scaling up".

(f) The next two sections outline the basic trade finance arrangements, the pre-export finance and the prepayment finance structures. For simplicity, it will be assumed that the commodity is crude oil and that its producers and exporters are SOEs fully owned and controlled by the sovereign. It will also be assumed the sales are all exports.

2. TWO TYPES OF COMMODITY-BACKED FINANCE. THE PRE-EXPORT FINANCE (PXF) STRUCTURE.[52]

2.1 The parties.

(g) The producer is an SOE responsible for the extraction and storage of the crude oil (the **Producer**).

(h) The entity marketing the crude oil is another SOE, which purchases the crude oil from the Producer and wants to sell it to the world markets (the **Seller**).

(i) The international buyers are likely to be entities who need the crude oil (usually refineries – **Final Buyers**) or major traders (**Traders**) who themselves purchase crude and on-sell it to other Traders or Final Buyers (each of the Final Buyer or the Trader, the **Buyer**). Long-term buyers are also called "off-takers".

52 *The Loan Markets Association publishes a term sheet and facility agreement for PXF transactions.*

(j) The creditors are banks (the **Lenders**) under a syndicated term loan facility whose administrative matters are conducted by one of the Lenders who is also responsible for holding the security on behalf of the Lenders (the **Agent**).

2.2 The elements of the transaction.

(k) The Seller borrows funds from (usually) the syndicate of Lenders (the **Loan**) under a loan agreement (the **Loan Agreement**).

(l) The Seller has a long-term agreement (the **Supply Contract**) to purchase crude oil from the Producer and uses [part of] the borrowed money to this end.

(m) The Seller enters into a long-term export agreement (the **Export Contract**) with a Buyer who we will assume is a Trader (it could also be an "oil major"). The payments under this Export Contract are an asset of the Seller (the **Receivables**). The commitment is usually to buy a specified number of barrels of crude over a specified period of time with each such purchase done at the prevailing market price. The Export Contract gives therefore the certainty to the Seller that the crude oil will be purchased, but the exact amount of Receivables from time to time will depend on crude oil market prices.

(n) The Trader enters into a number of further sales, so called "spot trades/sales" for specific quantities and for specific delivery times/places (the **Spot Sales**).

(o) The Seller undertakes to establish and maintain two accounts (usually with the Agent) outside its jurisdiction and usually in a jurisdiction where enforcement is swift and uncomplicated.

(i) The first account (the **Collection Account**) is the account where the Seller and the Trader agree that the Receivables will be deposited. Amounts in the Collection Account are applied first to any amounts due and payable under the Loan Agreement, second to fund the DSRA (see below) and any balance is released to the Seller.

(ii) The second account is one which collects a pre-agreed amount sufficient to meet the debt-service amounts payable under the Loan Agreement for a specified period (the **Debt Service Reserve Account** or **DRSA**). The DSRA is established to ensure that any Receivables shortfalls or interruptions can still be covered without bringing the finance arrangements to an immediate end and so permitting the parties to determine what remedial steps can be taken. The period (and the corresponding amount in the DSRA) will range from six months to a year or more. The period will be commercially agreed based on a common understanding of the possible reasons for the shortfall or interruption in the Receivables. These can be:

(A) reductions in the market price of crude oil;

(B) delays in the delivery of crude oil from the Seller to the Trader; and/or

(C) delays in the payment of the Receivables.

(p) Once the Loan Agreement has been fully repaid any balances in the DSRA are released to the Seller.

(q) The Loan Agreement is secured by:

(i) a security interest over the Supply Contract allowing the Lenders a claim to take the crude oil if the Seller defaults;

(ii) a security interest over the Export Contract, allowing the Lenders to receive the Receivables and exercise the rights of the Seller against the Trader if the Seller defaults;

(iii) a security interest over the Spot Sales, in case these generate receivables for the Trader earlier than the time the Receivables need to be paid into the Collection Account and to ensure that they are paid into the Collection Account; and

(iv) a security interest over the Collection Account and the DSRA.

(r) Given that the Producer and the Seller are SOEs, the Lenders will often require that the Loan Agreement also be guaranteed by the sovereign. The guarantee, like the pay-out provisions in structured project finance[53], acts as ultimate backstop of the viability of the transaction and is an assurance that if the sovereign does act in a manner which frustrates the legitimate expectations of the transaction parties, it will assume that responsibility.

2.3 Advantages, risks and possible pitfalls.

(s) The structure has some distinct advantages:

(i) it provides the SOEs with enough advance capital to fund the development of the oil fields and crude oil production at a cost which they would not be able to achieve relying merely on their credit or the credit of the sovereign;

(ii) it provides certainty that there will be a long-term buyer committed to buy certain minimum amounts of crude oil over a certain period;

(iii) the cost is (or ought to be) transparent, both the cost of the loan and its administration as well as the cost of the long-term arrangements.

(t) The structure has an inherent risk. The Receivables are all based on current market prices. This can be advantageous to the Seller in a rising market as it means more revenue for the same number of sold barrels of crude and extra revenue from the sale of any barrels not committed to the Trader. Equally, it can be disadvantageous in a falling market as this means more barrels of crude will have to be sold to maintain the same revenue and indeed the same minimum revenue for the debt service under the Loan Agreement.

(u) The market price risk in itself is not surprising or unusual. However, if the sovereign relies principally or almost exclusively for its revenues from the sale of crude oil, a falling market will see it deprived of any excess revenue. If the market fall is precipitous this can result in the bulk of the crude oil being sold towards only one end, the servicing of the Loan Agreement.

(v) The major pitfall is one of proper accounting. The arrangements concern “exports” and “trade” and a loan at the level of the SOE. Even though there may be a guarantee at the level of the sovereign, the debt management Officials may themselves not have full visibility of the arrangements and may not have modelled the crude oil’s price fluctuations. This will result in both internal and external misreporting which may have a number of unfortunate consequences.[54]

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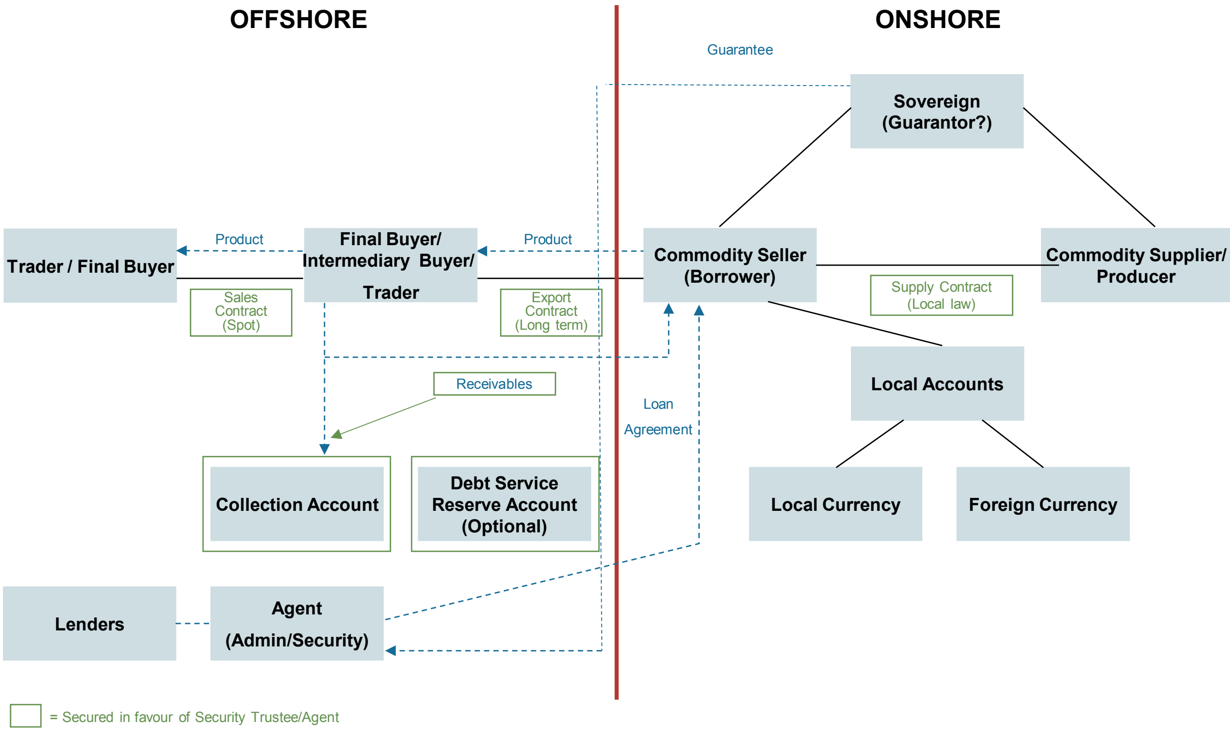
53 *See Schedule 1, Part 1, 1(j) above.*

54 *See 2.4 (Accountability and transparency) and 4.1 (Accounting and modelling – Cash-Flow and Debt Sustainability) of the main section of the handbook including the references to the IMF’s papers on accounting and disclosure.*

Example PXF structure



3. TWO TYPES OF COMMODITY-BACKED FINANCE. THE PREPAYMENT FINANCE STRUCTURE.

(a) The economic fundamentals of the Prepayment Finance structure are similar to those of the Pre-Export Finance structure. The main difference is that the loan agreement is advanced to the Trader but with recourse to its arrangements with the Seller. This changes the legal structure in the manner described below and adds some further challenges for the SOE and the sovereign.

3.1 The parties.

(a) As with the Pre-Export Finance structure, the producer is an SOE responsible for the extraction and storage of the crude oil (the **Producer**) and the entity marketing the crude oil is another SOE, which purchases the crude oil from the Producer and wants to sell it to the world markets (the **Seller**).[55]

(b) As with the Pre-Export Finance structure, the international buyers are likely to be entities who need the crude oil (usually refineries – **Final Buyers**) or major traders (**Traders**) who themselves purchase crude and on-sell it to other Traders or Final Buyers (each of the Final Buyer or the Trader, the **Buyer**). Long-term buyers are also called "off-takers".

(c) Again, as with the Pre-Export Finance

55 *For simplicity reasons the diagram below depicts the Seller and the Producer as one party. It also depicts the Lenders and the Agent in one box, again for reasons of simplicity.*

structure, the creditors are banks (the **Lenders**) under a syndicated term loan facility whose administrative matters are conducted by one of the Lenders who is also responsible for holding the security on behalf of the Lenders (the **Agent**).

3.2 The elements of the transaction.

(a) Unlike the Pre-Export Finance structure, the borrower of the funds from the syndicate of Lenders (the **Loan**) under a loan agreement (the **Loan Agreement**) is the Trader, not the Seller. The parties may agreement that the recourse on this Loan will be limited (see below).

(b) As with the Pre-Export Finance structure, the Seller enters into a long-term export agreement (the **Export Contract**) with a Trader under which the Seller will deliver to the Trader (or to the Trader's nominees, who can be Final Buyers) a specified number of barrels of crude oil per specified periods (the **Deliveries**).

(c) In what is perhaps the most important difference, in the Prepayment structure the Seller draws the Loan and uses it to pre-pay the Seller for the purchase of crude oil under the Export Agreement. The terms of this prepayment and the obligations of the Seller are sometimes recorded in a separate agreement, the **Prepayment Contract**. The terms of the Export Contract and the Prepayment Contract will depend on the circumstances. A key term will be an obligation on the Seller to have a minimum of number of Deliveries whose market price will be sufficient to cover the debt service of the Loan (the **Minimum Deliveries**).

(d) As with the Pre-Export Finance structure, the Trader enters into a number of further sales (the **Further Sales**) to on-sell the Deliveries.

(e) As with the Pre-Export Finance structure, the Trader undertakes to establish and maintain an account (usually with the Agent) where proceeds from the sale of the Further Sales and any amounts payable under the Export Contract and the Prepayment Contract will be deposited (the **Collection Account**). A DSRAas before is possible, but this will depend on the Trader's overall credit standing and bargaining position with the Lenders.

(f) Given that the Seller is an SOE, the Trader will often require that the Export Contract and the Prepayment Contract be guaranteed by the sovereign (the **Guarantee**).

(g) As with the Pre-Export Finance structure, the Loan Agreement is secured by:

(i) a security interest over the Export Contract and the Prepayment Contracts, allowing the Lenders to receive the Deliveries and any payments under these contracts directly or to their nominee;

(ii) a security interest over the Further Sales, allowing the Lenders to receive the payments under the Further Sales in priority to other creditors of the Trader;

(iii) a security interest over the Collection Account (and the DSRA, if there is one); and

(iv) in addition, a security interest over the Guarantee.

(h) The Trader will often negotiate that the recourse of the Lenders under the Loan Agreement be limited to the rights and receivables it has under the various contracts it has offered as security. In other words, the Trader is asking the Lenders to take the same overall risk vis-à-vis the Seller and the sovereign that they would take if the transaction were a Pre-Export Finance transaction.

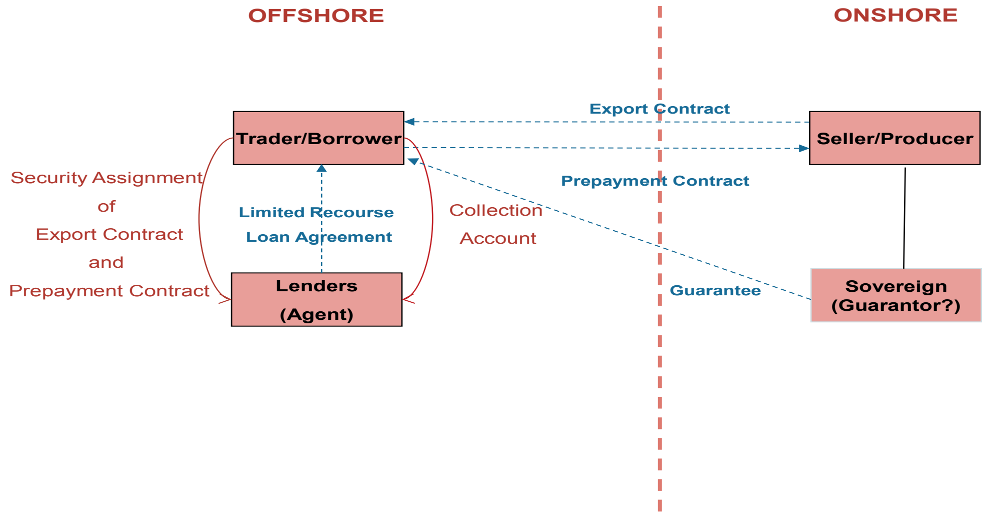
3.3 Where is the security granted by the SOE/Sovereign?

(a) In the Pre-Export Finance structure, the Seller provided a direct security for the Loan to the Lenders. Assuming registration of the relevant security interests, this security would be public, and creditors of the Seller would know about it. In the Prepayment Structure the Seller does not provide any direct security. The entity providing the security to the Lenders is the Trader. So why classify this transaction as a secured transaction for the Seller?

(b) Security can be established formally, *de jure*, as a matter of law (through a legal instrument creating a security interest classified as such by applicable law, or simply by operation of law), or *de facto* as a matter of lending structure, as a, so called, quasi-security.[56] The Prepayment Structure falls in the latter category.

(c) The economic effect of (i) buying in advance the commodity, i.e., buying future assets and (ii) paying a large amount in return, has the equivalent effect of lending the same large amount in return for a security interest over the same future assets. The prepayment structure transfers ownership immediately to the creditor in return for the advance. The secured assets have been transferred to the purchaser/creditor, but outside the formal framework of legal security. The formal secured loan structure creates a security interest which could, on enforcement, give the creditor almost the same rights, but only through the permitted enforcement routes prescribed by applicable law.

Example prepayment structure



4. ADVANTAGES, RISKS, PITFALLS, CRITICISMS AND POSSIBLE EVOLUTION OF THESE STRUCTURES.

4.1 Advantages.

Commodity backed financing structures have some distinct advantages:

(a) they provide the SOEs and their sovereigns with enough advance capital to fund the development of the oil fields and crude oil production at a cost which SOEs and sovereigns are unlikely to achieve relying merely on their credit or the credit of the sovereign. For a less economically developed sovereign (LED-CR Sovereign), with little else in its economy other than a commodity with high demand internationally and liquid markets this can be a major advantage;

(b) they provide certainty that there will be a long-term buyer committed to buy certain minimum amounts of crude oil over a certain period; and

(c) the cost to the sovereign is (or ought to be) transparent, whether it is the cost of the

56 *See further in Schedule 1Part 4 (Security in General – Negative Pledges), which includes a discussion on the differences between de jure and de facto security and considerations for Officials.*

loan and its administration (in the Pre-Export Finance) or the cost of the prepayment arrangements (in the Prepayment structure) as well as the cost of the long-term export arrangements (in both structures).

4.2 Market price risk.

(a) The structures have an inherent risk. The Receivables and the price paid for the periodic Deliveries are all based on current market prices. This can be advantageous to the sovereign/SOE/Seller in a rising market: more revenue for the same number of sold barrels of crude and extra revenue from the sale of any barrels not committed to the Trader. Equally, it can be disadvantageous in a falling market: more barrels of crude will have to be sold to maintain the same revenue and in particular to maintain the same minimum revenue for debt service under the Loan Agreement in either structure.

(b) The market price risk in itself is not surprising or unusual. However, if the sovereign is an LED-CR Sovereign and relies principally or almost exclusively on its revenues from the sale of crude oil, a falling market will see it deprived of any excess revenue and, therefore, fewer reserves for other uses. If the market fall is precipitous this can result in the bulk of the crude oil being sold towards only one end, the servicing of the Loan Agreements in either structure. [same AS 2.3 b above]

4.3 Proper assessment and reporting.

Commodity-backed financings risk not being correctly accounted for and reported. The arrangements concern “exports” and “trade”. They are unlikely to come within the direct remit of the finance ministry and the debt management Officials. As a result, Officials may not have full visibility of the arrangements. In particular, they may not have reviewed any modelling done at the level of the SOE by reference to crude oil reserves, Capex and Opex needs for future extraction, and crude oil’s price fluctuations and understood the impact that declines in market price will have on the sovereign’s revenues and its ability to meet other needs. Even if they have reviewed the modelling, they may not have gone beyond the modelling done at the level of the SOE for the purposes of the financial covenants of the Loan Agreement, which, even if commercially balanced, are creditor focussed.[57] This may result in both internal and external misreporting with a number of unfortunate consequences.[58]

4.4 Major criticisms.

Commodity-backed financings, particularly ones undertaken by LED-CR Sovereigns have been criticised. The criticism centres on the following:

(a) The market price volatility, where the material dependence of the LED-CR Sovereign on the commodity may provide an overall false sense of comfort when prices are high but may lead quickly to distress when prices decline.

(b) The private nature of the financing arrangements (these financings are done almost exclusively by way of loans or prepayment contracts whose terms are private) makes it very difficult for other creditors to gauge their standing and assess their position.

(c) The secured nature of the financing, their private nature and the absence of a broader economic base:

  (i) make debt management in a debt distress situation very difficult. With most valuable assets of the sovereign committed to one class of creditors, there is very little scope for the servicing of other creditors, including creditors which customarily have priority, like the World Bank and the African Development Bank; and

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57 *Loan Agreements in commodity-backed financings like Pre-Export and Prepayment financings, will contain a number of financial covenants which will provide important information to the creditors on the performance of the financing and will give them certain rights to demand additional commodity deliveries when market prices decline. These covenants are complex, and their discussion falls outside the scope of this handbook. Readers are encouraged to learn more about them by reviewing Loan Market Association’s pages on Pre-Export Finance and Export Finance and the A Guide to Key Resources: Trade Finance in the online Practical Law of Thomson Reuters mentioned in footnote 52 above.*

58 *On the general topic of proper accounting and disclosure, see the IMF’s paper Making Public Debt Public—Ongoing Initiatives and Reform Options, 31 July 2023 (here).*

(ii) outside debt distress, makes:

(A) multilateral development banks sceptical about the fiscal space available to the sovereign to service their long-term development finance; and

(B) private investors reluctant to invest on an unsecured basis, other than on terms which are likely to be economically very onerous.

(d) All these features risk making the sovereign's economy exclusively dependent on the commodity and the small set of creditors through whom it can successfully market the commodity.[59]

4.5 A way forward on [some of] these criticisms?

(a) The criticisms may be legitimate, but the overwhelming advantages noted above remain. But asking sovereigns, particularly LED-CR Sovereigns not to enter into such financing arrangements because of the risks, is not an option. Can anything be done to mitigate the risks?

(b) One possible option might be to find a way to make the terms of these financings public. The assumption behind this is that all other creditors, official and private, would be able to engage in more constructive conversations with an LED-CR Sovereign about its other economic development and financing options. Publicity is also expected to create the basis for corresponding domestic political economy discussions on the best way to use the blessings of natural resources and develop economically in other ways. Publicity will not of course mitigate the market risk or on its own increase the fiscal space in situations of distress. It will however enable all parties to better and faster explore:

(i) the opportunities for broadening the economic basis when the commodity markets are favourable; and

(ii) the options for a resolution of any debt distress exacerbated by unfavourable commodity markets.

(c) Publicity can be achieved in two ways:

(i) by publicising the financing arrangements which are done by way of a private loan; or

(ii) by arranging that the financing be made through the public markets with appropriate market disclosure.

(d) The difficulty with the first option is that, often, there will be important and legitimate commercial reasons for which the Buyers will not want public disclosure of their terms.

(e) The second option is less common but has been used. In 2016 the oil trader Glencore was reported to be "seeking to raise $550 million from investors via a debt issue [backed] by oil".[60] The transaction proceeded and in due course the bonds were issued in the market with the attendant disclosure. It was structured as Prepayment Finance with the Kurdistan Regional Government (**KRG**), but instead of a syndicated facility to Glencore, the funding was provided through a special purpose company which issued bonds and then lent the proceeds to a Glencore entity which in turn made the prepayment. The structure diagram from the disclosure documents is set out below.[61]

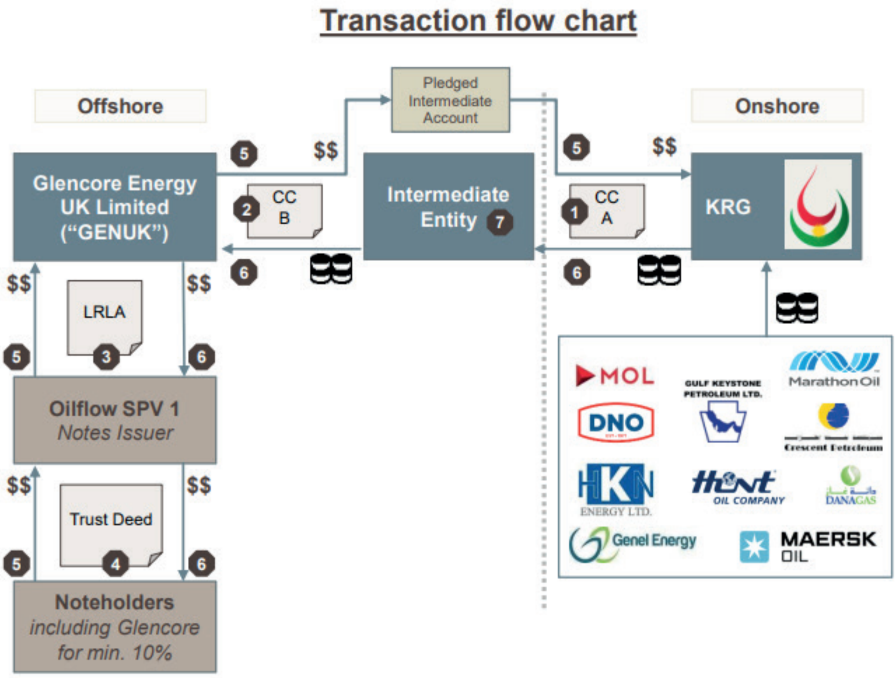
59 *These criticisms often form part of the discussion about the so called "resource curse". This refers to countries with an abundance of natural resources which, nonetheless, have less economic growth and development than countries with fewer natural resources.*

60 *See "Exclusive: Glencore seeks $550 million to raise stakes in Kurdish oil game" 18 November 2016 in Reuters (here).*

61 *See the "Listing Document" dated 13 January 2017. The transaction structure is set out on page 171 of the PDF. A summary of the commercial terms is set out on page 168 of the PDF.*

(I) Transaction Structure with the KRG

Notes proceeds will be lent on a limited recourse basis to GENUK to fund through the Intermediate Entity a prepayment to KRG



Legend:

1. *Commercial Contract A ("**CCA**") signed between KRG and the Intermediate Entity ("IE") for future deliveries, including a prepayment addendum;*
2. *Commercial Contract B ("**CCB**") signed between IE and GENUK for future deliveries, including a prepayment addendum (back to back with CCA) secured by an assignment by IE of its rights and interest under CCA to GENUK;*
3. *Limited Recourse Loan Agreement between GENUK and Notes Issuer secured by an assignment by GENUK of its rights and interest under CCB to Notes Issuer;*
4. *Trust Deed between Notes Issuer and the Trustee secured by an assignment by the Notes Issuer of its rights and interest under the Loan Agreement to the Noteholders;*
5. *Funding flows;*
6. *GENUK is responsible for making interest payments, while repayment of principal is discharged through the application of proceeds from the oil deliveries;*
7. *GENUK issues a performance guarantee of the Intermediate Entity under the CCB*

9

(f) Publicity has two aspects and Officials need to be aware of both. The narrower aspect has to do with transparency and disclosure of what the sovereign does. The wider aspect has to do with what the consequences of the transaction will be for the country, its reputation and the reputation of the other transaction parties. The Glencore transaction satisfied the narrow disclosure but was nonetheless criticised.[62] The transaction was with the KRG which emerged following the second Iraq war and the fall of Sadam Hussein to govern the semi-autonomous region of northern Iraq which is home to some, but not all, of the area's Kurdish population.[63] Having been given rights to Iraq's northern oilfields, the KRG sought to capitalise up front on the future flows of oil revenue to build enough of a treasury and pursue a policy of independent Kurdistan. The combination of falling oil prices which forced more production to be committed to the transaction and the political and military response from the government in Baghdad resulted in the bonds underperforming. The criticism was of the traders who enabled the political aims of the KRG and of the US pension* funds who invested in a risky asset.

(g) The criticism of the KRG transaction is based on its unique features. Nonetheless, it showed that these transactions can be done in a transparent manner and in a manner which passes on risk to creditors. Managing the political and reputational risk for the sovereign is always important and should always be present in the minds of Officials. The failure to manage it in the case of the KRG transaction is not on its own a reason not to pursue transactions which have disclosure, transparency and pass on risks to creditors.

(h) This kind of financing, backed by a particular asset will also be discussed in the next section.

62 *See Bloomberg article U.S. Teachers' Pensions Helped Fund War Over Oil in Iraq, 23 February 2021 (here) sets out the background to the transaction as recounted in the book The World for Sale, by Javier Blas, Jack Farchy, Random House, February 2021.*

63 *The population of about 30 million is spread over Iraq, Iran, Syria and Turkey.*

SECURED FINANCE – RECEIVABLES SECURITISATION/FINANCING

1. RECEIVABLES SECURITISATION/FINANCING – THE STRUCTURE.

1.1 Introduction.

(a) The Prepayment Finance structure considered above[64] shows how a Trader, Glencore, funded its prepayment to the relevant sovereign through a bond issue which was to be repaid exclusively from the payment proceeds of the crude oil delivered to the Trader under the arrangements. The same structure could have been employed by the Seller in a Pre-Export Finance structure. A long-term Buyer would still be required but the Loan could have been replaced by a bond issue placed with appropriate bond investors who would again be looking to be paid out of the proceeds of sale of the commodity.

(b) Securitisation - the technique of raising capital amounts in the bond markets on the back of future receivables is widely used in the commercial world. Securitisation is also sometimes used by sovereigns. Reviewing briefly how securitisations have and could be used, what are their advantages as well as their perils can further illuminate the topic of secured finance.

1.2 Securitisations – an outline.

(a) In broad outline a securitisation involves an owner of receivables selling them to a third party for purchase price which is mostly an up-front payment. The purchaser pays by borrowing money and repays the debt out of the proceeds of the receivables it now owns. In essence a traditional securitisation is a sophisticated form of factoring or discounting of debts.[65][66]

(b) The main parties to a securitisation are:

(i) the owner of receivables (the **Originator/ Seller**), such as banks or other corporates generating as part of their business large amounts of receivables owed to them from an equally large number of third-party debtors (the **Underlying Debtors**);

(ii) the buyer of the receivables which in almost all instances is a company specially established for the purposes of the transaction (the **Purchaser** or **SPV**). The SPV is almost always established so that it does not get consolidated in the accounts of the Originator. This makes any debt it raises not the debt of the Originator.

(iii) the creditors (**Creditors**), bondholders when the funding comes from the capital markets or, much more rarely, banks when the funding comes from loans; and

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64 See 4.5.

65 For an additional introduction to securitisation see Back to Basics: What Is Securitization? From the IMF's Finance & Development issue of September 2008 by Andreas Jobst (here).

66 This summary relies extensively on Part 2 of Project Finance, Securitisations and Subordinated Debt (being volume 7 of Law and Practice of International Finance), by Philip Wood, Third Edition, Sweet & Maxwell, London 2019. The book, which discusses only securitisations by corporates, also outlines the way securitisations are documents, explains the differences between some of the different species of securitisations deployed in the commercial world and discusses the reasons for which corporates and the financial markets favour it.

(iv) the servicer of the receivables (the **Servicer**), usually the Originator itself who is best placed to oversee and administer the collection of the receivables.

(c) The main transactions are:

(i) the sale of the Receivables by the Originator/Seller to the SPV;

(ii) the bond issuance by the SPV subscribed by the Bondholders (or loan advanced by the banks). The bond issuance may be done in various tranches of different bond series each with different degrees of risk;

(iii) the granting of security to the Creditors over the receivables to secure the borrowing;

(iv) the appointment of the Servicer to administer and collect the receivables on behalf of the SPV;

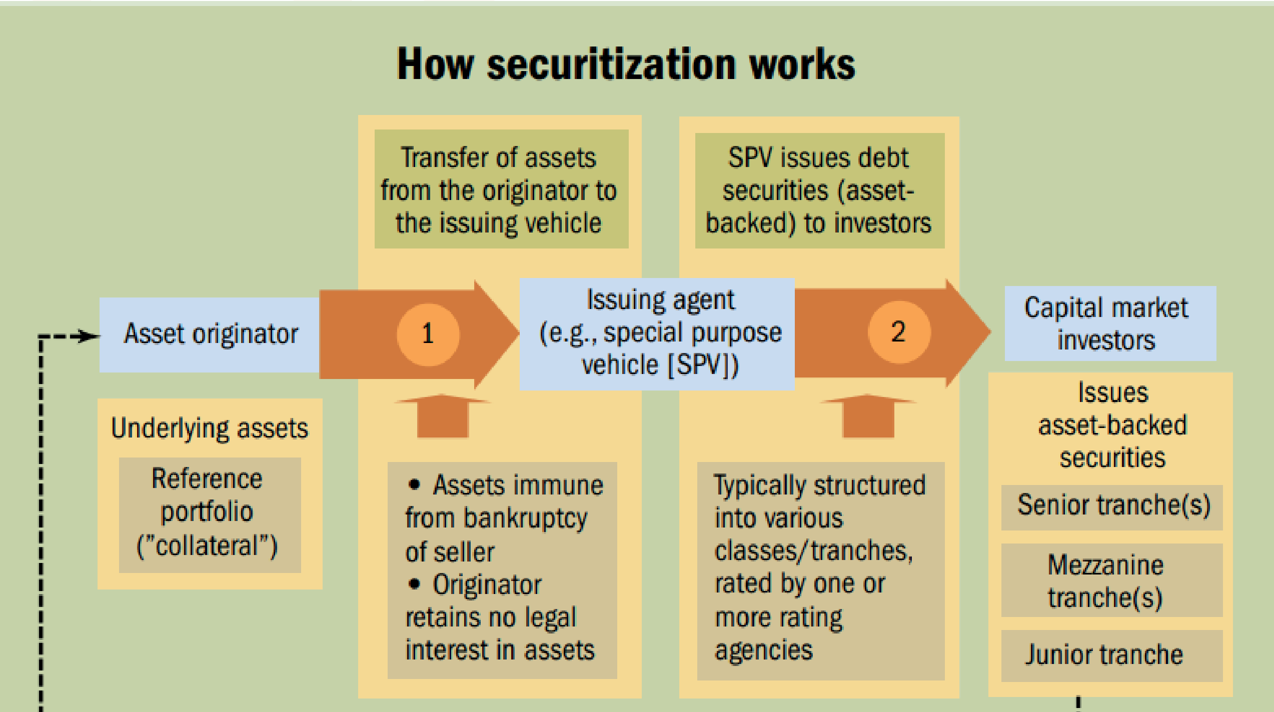
(v) the application of the proceeds of the receivables to pay principal and interest on the borrowings.

(d) The SPV may enter into ancillary arrangements to ensure that it does not have any liquidity mismatches between its debt-service obligations and the maturity and collection of the receivables.

(e) Where the financing is done through bonds these are often rated by a rating agency. The expectation and often the aim in these transactions is that the bonds will get a higher rating than the bonds issued by the Originator. This is because the rating agency (and the Creditors) consider just the quality and nominal size of the receivables, not the general credit of the Originator.

(f) To achieve this higher rating the receivables sold are almost always well in excess of what will be required to pay the Creditors. As a result, the SPV will end up with surplus revenues. These are paid back to the Originator through various mechanisms, e.g., as "deferred purchase price", debt service under a subordinated bond issued by the SPV and held by the Originator, additional "performance" fees for its role as servicer.

(g) The transaction converts assets – the receivables – which can be traded, if at all, in narrow, illiquid markets, into highly liquid, marketable and rated bonds – securities. This transformation gives the transaction its name: "securitisation".



FROM *BACK TO BASICS: WHAT IS SECURITIZATION?* FINANCE & DEVELOPMENT – SEPTEMBER 2008 (HERE).

1.3 Securitisations – economic substance vs legal form.

Securitisations replicate some but not all features of secured debt.

(a) In both securitisations and secured debt transactions, if the receivables generate proceeds in excess of what is required to repay the Creditors, these surplus amounts will be paid to the Originator.

(b) By contrast, in a securitisation the receivables are the only source for the repayments of the Creditors. If the receivables turn out to be insufficient to repay the creditors in full, the Originator does not have any obligation to cover the difference. In a secured debt transaction, the receivables would be provided as security, but if they turned out not to be sufficient, the debtor (the Originator) would still have to pay the difference.

1.4 Why do banks and other corporates do securitisations?

Broadly, there are three sets of reasons, accounting, capital-enhancing and regulatory.

(a) Accounting. Depending on the accounting rules, the securitisation enables the Originator to achieve all of these which make the Originator's balance sheet more robust:

(i) raise money without the amounts raised being classified as a liability on its balance sheet;

(ii) use the proceeds of the sale to reduce its liabilities; and

(iii) keep the excess return from the realisation of the receivables and record them as profit;

(b) Capital-enhancing. These would include:

(i) Cheaper financing. By (A) isolating the receivables and making them available to the Creditors, (B) pooling more receivables in nominal terms than required for the servicing of the SPV's debt and (C) tranching the bonds of the SPV, the overall interest cost of the SPV is much lower than the interest cost of a direct debt raised by the Originator.

(ii) Additional income. The receivables on the whole generate more interest income than the interest cost of the SPV. This is an additional benefit for the Originator as in most cases this interest differential will be returned to it as part of the arrangements for the rebating of excess funds by the SPV to the Originator.[67]

(iii) Capital immediately available. Securitisation allows the Originator to raise capital immediately, instead of waiting for the receivables to be repaid.

(iv) New Sources of funding – new markets. A well-structured securitisation can achieve the highest of credit ratings, even when the Originator has low credit ratings. This enables the Originator to access investors who have minimum investment grade requirements and would otherwise been inaccessible to it. It also allows the Originator to become better known in markets which it aspires to join in its own right.

(v) Risk management. Although the pool of receivables is selected at the outset to be more than sufficient to service the debt of the SPV, the structure is still a limited recourse structure to just the receivables transferred to the SPV. The risk of unexpected downturns where the receivables might lose value and all of the debt of the SPV cannot be serviced, the Originator has no further obligations. The Creditors have recourse to the receivables and nothing more.

(c) Regulatory. Banks and other regulated credit institutions will be interested in managing their capital adequacy requirements and so use securitisations for two principal reasons:

(i) Regulatory capital management. The transfer of the receivables to an SPV whose accounts are not consolidated with those of the Originator reduces the amount

67 *See 1.2(f) above.*

of regulatory capital that these institutions must carry (or raise if they have less than required) to satisfy capital adequacy ratios.

(ii) *Balance-sheet clean up*. After periods of general economic downturn these institutions are likely to have seen their assets, their loans to their customers, perform poorly or not perform at all. This is a big drag on their activities, as it traps regulatory capital, and constrains severely their ability to start lending again. Securitisation of these non-performing loans (which is of course done by sales at a discount to the nominal amount of the receivables) enables these institutions to clean their balance sheets and refocus on lending.

2. SOVEREIGNS AS ORIGINATORS OF RECEIVABLES.

1.5 Background

(a) Securitisations with sovereign originators (or major SOEs with the express or implicit guarantee of the sovereign) were more common in the 2000s. They continue to be used and are likely to continue for as long as streams of high-quality receivables can be identified and can be structured in an overall advantageous manner for the sovereign originator.

(b) Securitisation finance for sovereigns requires appropriate pools of receivables. Historically these have included the following:[68]

(i) mortgage loans guaranteed by the sovereign as part of social housing programmes;

(ii) receivables from activities which are the state monopolies, such as telephone receivables, airline ticket receivables, lottery ticket receivables;

(iii) receivables paid by third thirties for use of the sovereign's territory as for example the fees paid by airlines for the use of the sovereign's airspace;

(iv) commodity receivables (such as from crude oil);

(v) royalties from the operation of privatised activities such as oil and gas royalties;

(vi) other export receivables capable of being scaled in amounts and over time; and

(vii) tax revenue receivables.

1.6 Key considerations for sovereign securitisations.

(c) Some of the main drivers for sovereigns doing securitisations are the same as for corporates but there are also some fundamental differences. The two most important differences are that sovereigns have (or ought to have) different accounting objectives and have no regulatory constraints. The reasons for the absence of regulatory constraints are clear. Sovereigns are creators of the laws and so any self-imposed regulatory constraint is meaningless, unless it creates legal rights for third parties, something which is within the sovereign's discretion. The closest a sovereign comes to having something akin to capital adequacy goals is the management of its foreign currency reserves which everybody would agree should be "prudent".

(d) The challenge of sovereign accounting was identified at the outset of this handbook[69]as one of the major challenges sovereigns face. Proper accounting and proper disclosure are important for the cash-flow aspects of debt management, for the management of and communication with the broad investor audience (current and prospective), for the investment and economic development choices available to the sovereign and for accountability. In the 2000s a number of sovereigns used securitisation to "window dress" their national finances, a practice which was broadly criticised and was, in the case of Greece, alleged to have contributed to its sovereign debt crisis.[70] The sovereigns engaging in "window-dressing" practices were not confined to smaller and economically weaker sovereigns, but included some of the most developed and highly rated sovereigns, such as Germany. Lessons were learned with "window-dressing" practices replaced by sound accounting and transparency policies.

(e) The beneficial similarities that sovereign securitisations have with corporate ones have to do with finance. All "capital enhancing" reasons corporates have in doing securitisations identified in 1.4(b) above apply

68 *For an early overview of sovereign securitisations see Securitization of Future Flow Receivables: A Useful Tool for Developing Countries in IMF's Finance & Development March 2001, Volume 38, Number 1, by Suhas Ketkar and Dilip Ratha (here).*

69 *See 2.4 (Accountability and transparency) and 4.1 (Accounting and modelling – Cash-Flow and Debt Sustainability) of the main section of the handbook.*

70 *See Securitisation: Sovereigns window-dress national finances, Euromoney, 1 July 2005 (here).*

equally to sovereigns.

(f) Securitisation finance bears more than a family resemblance to commodity finance[71]: streams of receivables are being pooled together in large scale to achieve a higher creditworthiness to that of the sovereign/SOE/Seller/Originator and then used to support debt raising on much better terms than what the sovereign/SOE would be capable of achieving through a direct and unsupported effort. Being closely related they share some of the same advantages and concerns. Purpose of transaction, management of funds raised, overall relationship with sovereign debt management, and proper accounting are the main areas of shared consideration of advantages and concerns. In particular, weaker economies which can identify valuable pools of receivables run the risk of committing them all to a small group of creditors leaving no space for others (see Schedule 1Part 2, 4.4 above).

71 Discussed above in Schedule 1Part 2.

SECURITY IN GENERAL – NEGATIVE PLEDGES

This section provides a brief overview on security: its various types, how it operates, the advantages it confers and the corresponding constraints it imposes on the debtor. It also briefly discusses the Negative Pledge Covenant, its various forms and the purpose they serve for creditors. Finally, this section summarises what should be key considerations for Officials with respect to security and negative pledges.

1. WHAT IS "SECURITY" AND WHY DO CREDITORS ASK FOR IT

(a) "Security" in the broadest sense is some sort of arrangement where an asset of the debtor is made available in priority and/or exclusively to one or more of its creditors to mitigate (or "secure") the risk they have from their debt exposure. Security is sometimes referred to as "lien", "collateral", "encumbrance", "charge", "pledge", "mortgage", or just "security interest".

(b) Security can be created by agreement, by operation of law (e.g., liens over ships in ports for port dues) or by statute. The security discussed in this handbook is only the one created by agreement between creditor and debtor.

(c) Security is almost always provided in addition to obligation of the debtor to pay the creditor. This means that if there is a shortfall between the creditor claims and the realised value of the security, the creditor can claim for the shortfall. In rare circumstances there is "limited recourse" only to the realised value of the security. Unless expressly mentioned, all references to debt and security arrangements in this handbook are for "full recourse" rather than "limited".

(d) The most common reason for which a creditor wishes to have security is that a valid security interest achieves super-priority on the debtor's insolvency. As a result, such a security interest reduces the creditor's exposure to the insolvent debtor.[72]

(e) In some instances, the security is taken for more complex reasons, referred to as "defensive". This will, for instance, be the security granted in connection with certain types of project financings. In these financings the overall project structure[73] is designed so as to generate cash-flows which will pay for the operation and maintenance of the project, repay the debt and generate an equity-type return for the project sponsors. In these instances, the security granted over the project's accounts, receivables and other assets seeks not to reduce exposures on insolvency, but to ensure that no other creditor can interfere with the cash-flow that the project is designed to generate.

2. SECURITY CAN TAKE A WIDE RANGE OF FORMS

(a) It can be <u>formal, *de jure*, security,</u> where the debtor's assets are mortgaged or pledged, and the arrangement is recorded publicly. Examples of such assets are land, ships, aircraft, industrial equipment, but also receivables of any type, other contractual rights, intellectual property etc. The characteristic of this security is that it is public, so that other creditors of the debtor are in a position to assess these arrangements when extending credit to the debtor. In all these instances the public recording is a requirement and failure to comply with it voids the security. Public

72 See Philip Wood, *Principles of International Insolvency (2nd edition, Sweet & Maxwell 2007) section 25-021 which discusses this aspect of security in the context of sovereign financing.*

73 *See Schedule 1Part 1 (Secured Finance – Project Finance).*

recording of security interests over assets is an important public policy goal. How it can be established over all security arrangements, *de jure* and *de facto*, is a topic which is constantly discussed.

(b) Security can also be <u>*de facto*</u> security also called quasi-security. This security is not recorded and so will, unless either made public voluntarily or as a consequence of one of its features (e.g., sale of a property to be leased back), it remains secret between the debtor and the secured creditor. Quasi-security can be effected in a number of ways. A common way for assets that can otherwise be mortgaged (e.g., land, ships and aircraft) is for the creditor to acquire ownership and then lease the asset to the debtor, on cash-flow terms equivalent to a loan cash-flow. Receivables of a debtor which could otherwise be pledged can also be sold for an amount representing their present value but with full recourse to the debtor if any of these receivables are not paid in full and on time. Another common example of quasi-security can be money deposited with the creditor which the creditor can set-off against the debt owed to it. This can be replicated more broadly where the creditor has possession or control of the debtor's secured asset and has self-help rights over it. There are also a host of other arrangements using legal tools such as trusts. All these quasi-security arrangements are of some complexity and rely on the location of the secured asset and the laws of the jurisdiction where the asset is located.

3. REASONS FOR CHOOSING QUASI-SECURITY OVER FORMAL SECURITY

(a) In some cases, a quasi-security is chosen because of a differential accounting treatment. For example, accounting standards in a jurisdiction may allow debtors not to record the sale & lease-back of a property as a long-term liability, but rather to record it as a short-term obligation with no reference on the balance sheet.

(b) In some other instances, a quasi-security is chosen over a registered security interest because it does not require publicity.

(c) There are some good reasons for taking *de facto* as opposed to *de jure* security.

(i) *De jure* security may not be formally available for the relevant asset under applicable law;

(ii) De jure security may be available, but the enforcement process is long and ineffective in providing what is appropriate for the role of security in the circumstances. For example, it may require that the secured asset be sold through an auction at the end of a process which may last months or even years. This would be fatal for a secured transaction which relies on the immediate liquidation of an asset such as a widely tradeable commodity with market prices changing daily, let alone within months or years. *De facto* security on the other hand usually means outright ownership of the secured asset permitting self-help is swifter, more efficient and avoids long delays on enforcement on insolvency.

(iii) *De jure* security may require expensive registration and an expensive enforcement process which increase transaction costs making the transaction more expensive for the debtor.

(iv) For corporates the accounting treatment of each security type may be different giving them a legitimate reason to choose one over the other. For example, accounting standards in a jurisdiction may allow debtors not to record the sale & lease-back of a property.

(d) There are also some less good reasons for taking *de facto* and not *de jure* security, especially for a sovereign. The principal ones are:

(i) *De facto* security is not registered, making what may be a private debt arrangement even less transparent. Given that the security involved may be considerable (e.g., the principal commodity exports of a LED-CR Sovereign) this puts all other creditors of the sovereign at a distinct information disadvantage. At times of

debt distress this may cause long delays and obstacles in its resolution.

(ii) Accounting is not a science. Perfectly rigorous and widely acceptable accounting standards for corporates may provide radically different answers on how a specific transaction needs to be recorded and reported.[74] What is true of corporate accounting is even truer of sovereign accounting. Choosing a *de facto* security structure so as to argue that the underlying transaction (e.g., a prepayment of the purchase of commodities, a securitisation of future receivables) should not be included in the sovereign's debt is almost always a path that Officials ought not to follow. Not including what is in fact debt as debt in the national accounts, distorts the true position of the sovereign, may mislead existing creditors, potential investors and the public and may lead to internal non-recognition and non-inclusion in the overall sovereign debt cash-flows.

4. THE NEGATIVE PLEDGE COVENANT[75]

4.1 What is it?

The Negative Pledge Covenant is a near universal provision in any unsecured debt instrument. It can take many forms, but its core provision is "*the debtor will not (and will procure that certain connected parties to it will not) create or permit to exist any security interest on its assets*". It itself is not a security interest. It is an undertaking by the debtor not to create security interests. As a result, any time a debtor considers whether to enter into a secured finance transaction it must see if there is a negative pledge covenant and its exact scope.

4.2 Purpose of the Negative Pledge Covenant

The purpose of the Negative Pledge Covenant is to protect unsecured creditors.

(a) It has already been noted that secured finance operates by giving priority to the secured creditor and subordinating the remaining creditors, since the debtor has access to a reduced pool of assets. The bulk of creditors are almost certain to be unsecured. These creditors are therefore interested in having a Negative Pledge Covenant because their credit analysis always depends on those assets of the debtor which are available and can continue to generate revenues.

(b) The credit analysis can take into account security existing at the time the new debt is contracted. But it will be undermined if security is granted in the future, hence the forward-looking statement of the negative pledge. The forward-looking aspect of the provision also wants to anticipate a possible time of debtor difficulties, when it can only raise debt on a secured basis at the very same time that the remaining creditors will wish to ensure that the debtor's assets remain unencumbered.

(c) The Negative Pledge Covenant is not, however, only forward looking. It prohibits existing security interests: "the debtor will not … permit to exist". Nonetheless, certain existing security interests will not be capable of being discharged and the new creditors may permit them and take them into consideration in their credit analysis. Of course, the ability of the creditors to do a proper credit analysis will also depend on the disclosure by the debtor of existing security interests at the time the new debt is contracted so that their subordinating effect can be assessed.

(d) Negative Pledge Covenants will also vary in the type of their prohibition. Whereas loans will include the strictest (but also the most bespoke) provisions, bonds will allow security to be granted to other bonds, provided the security is shared by them as well. The intention is to preserve parity between bond issues and have a level playing field when it comes to trading the bonds.[76]

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74 *See also 2.4 (Accountability and transparency) in the main section above.*

75 *See section 17-037 and following in Comparative Law of Security Interests and Title Finance (volume 3 of Law and Practice of International Finance), by Philip Wood, Third Edition, Sweet & Maxwell, London 2019.*

76 *The author is not familiar of any instance where bondholders had reason to invoke the "automatic" security interest intended to be created by the "same security to us" provision. The effectiveness these provisions is doubtful, see*

(e) The Negative Pledge Covenant promotes inter-creditor equity, which, as discussed earlier[77], should also on the whole be a goal of Officials. By contrast, security especially over a substantial range of assets or a set of strategic assets of the debtor, gives the secured creditor a disproportionate power in determining how a distressed situation will be resolved.

4.3 Scope and Types of Negative Pledge Covenants

(a) Negative Pledge Covenants contain four other important elements which define their scope. These are:

(i) the definition of "Relevant Debt", i.e., type of debt over which security cannot subsist or be created;

(ii) the definition of "Debt" itself, which will not rely on accounting treatment of debt – the range of which will depend on the type of transaction – a loan is likely to be a lot more comprehensive than a bond. In loans it will range from borrowed moneys and amounts raised through bonds, to forward sales with deferred payment, pre-payment with deferred deliveries, derivatives and guarantees;

(iii) the definition of prohibited "security interest" – again the range will depend on whether the debt is a loan, a bond or something else. In loans the range is usually extensive to include both formal/*de jure* and *de facto*/quasi security;

(iv) exceptions to the general prohibition. These will be bespoke to the transaction and may range from specified existing security interests, set-off arrangements in the ordinary course, liens arising automatically by operation of law (although this exception would not be included in a sovereign debt instrument), to categories of secured finance without recourse but subject to certain limits (this would permit certain types of project finance and securitisation), and even possibly other security interests subject to limits on amounts secured and types of assets.

(b) The Relevant Debt in Negative Pledge Covenants given by sovereigns is limited to "external debt". This is usually defined as debt payable in, optionally payable in, or calculated by reference to any foreign currency, or owing to non-residents. In the cases of bonds, the Relevant Debt is further restricted to debt in the form of bonds and which is listed or capable of being listed on any stock exchange.

4.4 A special type of covenant – the World Bank Negative Pledge Covenant[78]

(a) Lenders within the World Bank group and other multilateral development banks will deploy a very strict and very comprehensive Negative Pledge Covenant which forms part of their general conditions. It reads as follows:[79]

(b) Section 6.02. Negative Pledge (a) It is the policy of the Bank, in making loans to, or with the guarantee of, its member countries not to seek, in normal circumstances, special security from the member country concerned but to ensure that no other Covered Debt shall have priority over its loans in the allocation, realization or distribution of foreign exchange held under the control or for the benefit of such member country. To that end, if any Lien is created on any Public Assets as security for any Covered Debt, which will or might result in a priority for the benefit of the creditor of such Covered Debt in the allocation, realization or distribution of foreign exchange, such Lien shall, unless the Bank shall otherwise agree, ipso facto and at no cost to the Bank, equally and ratably secure all Loan Payments, and the Member Country, in creating or permitting

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Philip Wood, op.cit., section 17-050.

77 *See 4.14 (Provisions ensuring intercreditor equity. of the main section above.*

78 *See Understanding the Implications of the Negative Pledge Clause on Sovereign Borrowers by Nicole Kearse, 23 February 2020, in the African Legal Support Facility's blog (here).*

79 *See in full section 6.02 in General Conditions for IBRD Financing: Investment Project Financing and here.*

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the creation of such Lien, shall make express provision to that effect; provided, however, that if for any constitutional or other legal reason such provision cannot be made with respect to any Lien created on assets of any of its political or administrative subdivisions, the Member Country shall promptly and at no cost to the Bank secure all Loan Payments by an equivalent Lien on other Public Assets satisfactory to the Bank.

(c) [non-members] undertakes that…. (i) if it creates a Lien on any of its assets…[it will] equally and rateably secure the payments of all Loan Payments…..(ii) if any statutory Lien is created …it will be granted at no cost to the Bank…..

(d) the provisions of paragraphs (a) and (b) above shall not apply to (i)any Lien created on property…and (ii) any Lien created in the ordinary course of any banking transaction and securing a debt maturing not more than one year after the date on which it is originally incurred.

(e) The Member Country represents … that no Liens exist on any Public Assets, as security for any Covered Debt, except those listed in a notification from the Member Country to the Bank and those excluded pursuant to …

(f) [above].

"Covered Debt" means debt payable in foreign currency.

"Lien" includes mortgages, pledges, charges, privileges and priorities of any kind.

"Public Assets" means assets of the Member Country, of any of its political or administrative subdivisions and of any entity owned or controlled by, or operating for the account or benefit of, the Member Country or any such subdivision, including gold and foreign exchange assets held by any institution performing the functions of a central bank or exchange stabilization fund, or similar functions, for the Member Country.

(g) The covenant has two distinct features.

(i) First, it extends over all "Public Assets" which include assets of the central bank, political subdivisions, SOEs, etc. There is nothing comparable, extensive and indeed draconian in any debt instrument with a private sector creditor.

(ii) Second, the covenant has an "automatic" provision, similar to the one found in bonds. If the debtor were to grant a security interest ("lien" in the text) to another creditor, then the debtor will have to extend the same "lien" in favour of the World Bank creditor.

(h) Officials need to understand the scope of the WB Negative Pledge Covenant so as to ensure they do not breach it. To better apply it and also better to discuss with World Bank lenders possible exceptions to it,[80] it is important also to consider the policy purpose of such a draconian provision.

(i) World Bank lenders finance development and are focused on less developed economies. The financing is provided in most cases on "concessional terms", which means, among others, that the interest costs are low, much lower than the sovereign could obtain from the markets and that the tenor is long.[81] Concessional terms are intended to assist the country develop long term recognising that high interest costs and short-term maturities may not allow the fiscal space and the time needed for the sovereign to see its economy grow.

(ii) Concessional terms are provided thanks to the ability of the WB creditors to access the markets at the best possible rates. This is made possible by the support of their members and by their "preferred creditor status" (**PCS**). The latter is a reference to the expectation that their debt will not be rescheduled or restructured and will be paid in full and on time. The PCS is also enjoyed by other such multilateral development banks as well as by the IMF.

80 *For a suggested exception see Getting the World Bank Out of Development's Way: The Case for a Project Finance Exception to the World Bank Negative Pledge Clause, by Kate Barth, SSRN, 18 March 2013, here.*

81 *See 4.4(d) below for the two World Bank lenders and their concessional terms.*

In a distress situation, where the PCS will be most relevant, any IMF program will require that the PCS be respected.

(iii) Some of these less developed economies are also rich in commodities, they are what was described earlier as LED-CR Sovereigns. These commodity-rich countries are both eligible for concessional term financing from World Bank lenders and also, as discussed in the previous sections, able to raise finance on very advantageous terms through secured finance or relevant securitisations based on their commodities. Not only is an alternative advantageous means of raising finance possible, but it sometimes has the advantage that it can be arranged and put in place a lot faster than the World Bank lenders or other multilaterals could.

(iv) Unfortunately, debt distress is not uncommon for the less economically developed sovereigns, including the ones blessed with commodities. Where LED-CR Sovereigns have raised funds through Commodity Finance or Securitisation arrangements, in a distress situation there may be very little for other creditors, including creditors, like the World Bank lenders, who are meant to enjoy PCS.[82] World Bank lenders seek to protect themselves against exactly such situations through their negative pledge provisions.

(i) The World Bank lenders are:

(i) the ***International Bank for Reconstruction and Development*** (**IBRD**). It lends to middle-income countries at interest rates that are lower, and repayment periods that are longer, than the commercial banks ("concessional financing"). The lower cost of lending by the IBRD allows borrowers to pursue projects with an economic development benefit that would otherwise be uneconomical; and

(ii) the ***International Development Association*** (**IDA**). The IDA is responsible for helping the world's poorest countries. Overseen by 173 shareholder nations, the IDA aims to reduce poverty by providing loans and grants for economic development programmes designed on even more favourable concessional terms than the IBRD. IDA lending may feature a low or even zero interest rate, and repayment periods of 30 to 38 years, including a 5- to 10-year grace period. The IDA may also provide grants to countries at risk of debt distress.

5. CONCLUSION - WHAT SHOULD OFFICIALS CONSIDER?

(a) Sovereign secured debt is not common and, in this sense, almost all secured finance transactions of sovereigns are "non-traditional". The permutations in which debt can be made available when blended with commodities or other tradeable and highly marketable assets are many and can change easily as market practices evolve.

(b) Debt can be a tool for economic growth when applied for the right purposes <u>and</u> managed prudently. Debt can also drag down an economy if it poorly managed <u>or</u> if the purposes for which it was applied fail or were simply not appropriate ones. When security is added to it both positive and the negative trajectory will be magnified.

82 *See previous discussion, in particular 4.4 in Schedule 1Part 2.*

CHAPTER THREENEW CREDITORS – NEW DEBT INSTRUMENTS

1. OVERVIEW

The sovereign debt market has seen a number of new investors enter it in the last 30 years or so. The new investors come from countries which have experienced economic growth and have generated savings available for investment worldwide. As these new investors joined the global capital markets, they brought along their own terms and forms of investment.

Given the substantial amounts which these investors have already mobilised and can still mobilise, it behoves Officials to develop relationships with them and understand the special features of their debt instruments.

These investors come principally from China and the emerging economies of the Islamic world but also from other newly emerging creditor economies. They provide funds either through:

- their state and commercial banks, as is the case with China;
- investment instruments subscribed by investors, as is principally the case with investors from the Islamic world; or
- regional development banks, sometimes referred to as "plurilaterals", established by select countries to promote investment and development.

These investors and the means through which they invest - the debt instruments they use can fairly easily be called "non-traditional". In some parts of the world, they and their debt instruments are already mainstream. Nonetheless, they still continue to be new and not always fully tested through full economic cycles.

The sections of this chapter will discuss in a select manner each of these three types of investors and some of the provisions of their debt instruments. The aim is not to give a comprehensive review. The aim is rather to make Officials aware of some key features of these debt instruments which will help them enhance their relationships with these new investors and protect the legitimate interests of their sovereigns.

PART 1 ISLAMIC DEBT INSTRUMENTS AND ISLAMIC INVESTORS

1. ISLAMIC FINANCE - ITS MAIN PRINCIPLES – MITIGATING UNCERTAINTY[83]

(a) Islamic finance is not new. It has been around for centuries, having grown and developed in accordance with the principles of Islamic law (Sharia). With the wealth increase in the wider Islamic world these finance techniques have further developed to allow Islamic investors to invest their savings in a manner consistent with their faith.

(b) Sharia's main principles are:

(i) Usury, a return calculated on principal amounts lent, is not permitted. Any obligation to pay interest is therefore void and payment and receipt of interest is not allowed. This means that loans and bonds which have a return calculated on principal amounts cannot be used in Islamic financing.

(ii) Speculation is not permitted and contracts involving it are void. Commercial transactions and the attendant commercial speculation is permitted, but the line is drawn (not always an easy task), on speculation which, like gambling, does not depend on productive effort.

(iii) Unfair contracts leading to unjust enrichment are void. What is unfair and exploitative is not always easy to tell so contracts will have to be analysed on a case-by-case basis, but contracts where there is risk sharing are likely to satisfy the test.

(iv) Commercial arrangements which may otherwise be permissible, are only permissible if the assets which are the subject of these arrangements are themselves permissible.

(v) Contracts with uncertainty, such as insurance contracts, are void.

(c) In summary, for profits to be permissible they must be derived not from usury, but only from bona-fide non-speculative, non-exploitative commercial risk-taking and trading involving appropriate assets.

(d) Together these principles introduce legal uncertainty on whether any specific transaction is within the bounds of Islamic law. For any financial transaction that aspires be large and scalable, this uncertainty needs to be resolved. Islamic banks have been addressing this challenge by establishing boards of Islamic law experts who review the proposed transactions. In addition to reviewing individual transactions these Sharia boards have been developing the general law and policy. The result is increased legal certainty, which has allowed the markets to grow.

83 *There are a number of introductions to Islamic finance, the relevant principles of Sharia and the structure of the investment instruments used. The text in this chapter has relied in structure and presentation on the following, all of which should be consulted for further understanding of Islamic financing: A guide to key resources: Islamic finance (here), Islamic finance: UK law overview (here) and Islamic finance: Transaction structures (here) in the online Practical Law of Thomson Reuters; internal training materials of Allen & Overy LLP, bond and sukuk issues of a few sovereigns;*

2. ISLAMIC FINANCE INSTRUMENTS 84

There are many Islamic finance instruments which can be surveyed at any of many available sources. Two are presented here in very basic outline as (i) they are the ones most likely to be used by sovereigns and (ii) they demonstrate the effort to design structures which generate returns out of the trading of permissible assets rather than the time-use of money. These are the *reverse murabahas* (*tawarruq*), sometimes just called Murabahas, which are used instead of loans and the *sukuks* which are used instead of bonds.

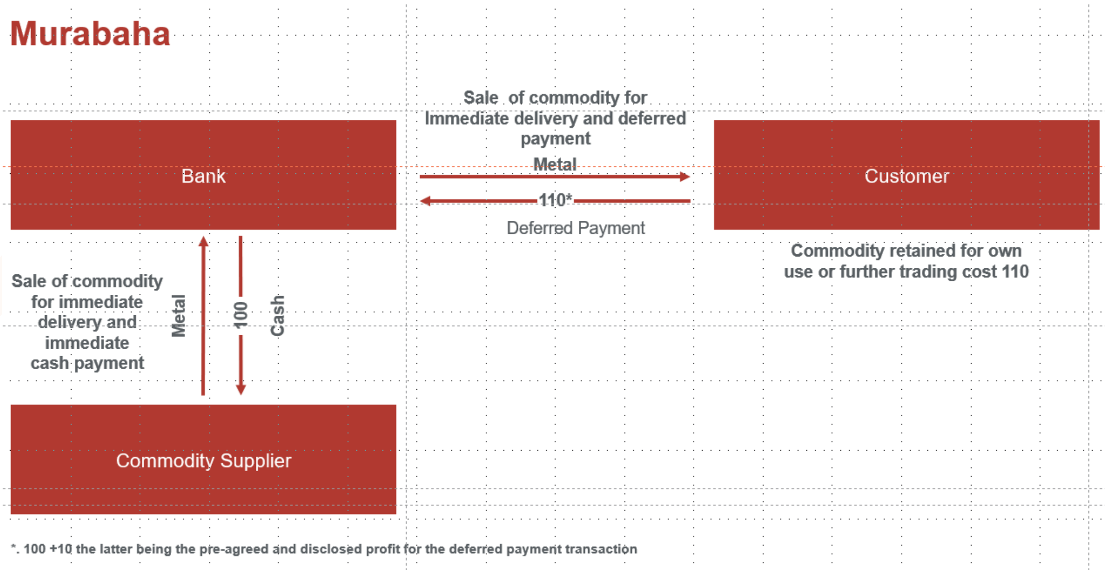
2.1 Murabaha

The Murabaha is a simple trade finance transaction involving an appropriate asset, e.g., a commodity such as metal.

(e) The bank will buy the appropriate asset from a seller for cash and for immediate delivery.

(f) The bank will then immediately sell and deliver the same asset to the customer/final buyer/ debtor at an agreed price at a disclosed and agreed mark-up on the bank's purchase prince representing the bank's profit. The purchase by the bank and its immediate on-sale to the customer will happen nearly simultaneously. The bank's profit is considered to derive from a sale transaction and is not prohibited.

(g) The marked-up price owed by the customer is almost always deferred. It corresponds to what would be a financing arrangement for the purchase of the asset.



2.2 Reverse Murabaha (tawarruq)

The reverse Murabaha is a transaction at the end of which the customer ends up with a cash amount and an obligation to make deferred payments to the bank.

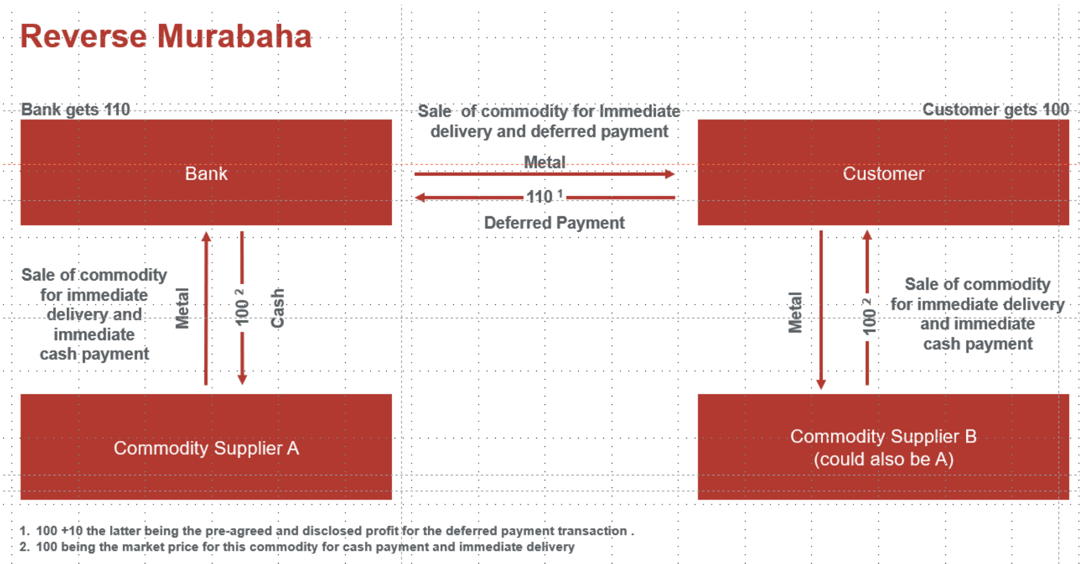
(a) The bank will buy the appropriate asset from a seller for cash and for immediate delivery.

(b) The bank will then immediately sell and deliver the same asset to the customer on a deferred payment basis. So far, the transaction is like a Murabaha.

(c) Then, the customer will immediately sell the

84 *As with all other references to concrete financing arrangements in this handbook, the summaries presented here are intended to elucidate some fundamental concepts. They are not intended as a full presentation, much less as advice for specific transactions. Officials should always seek the advice of appropriate advisors and use this handbook as a guide of key issues that will help them better to discuss with advisors and negotiate with counterparties specific transactions.*

same asset to a third party (often the original seller) for immediate delivery and cash payment. The end result is that the customer has received a cash amount from the third party and has a deferred payment obligation to the bank. This corresponds to what would be a financing through a loan by the bank to the customer.



2.3 Sukuk

(a) What is a sukuk

(i) A *sukuk* is a certificate or note which represents an interest in tangible assets. The interest in these tangible assets can be an interest in fixed periodic and principal payments, i.e., an interest in a cash-flow with fixed characteristics.

(ii) The underlying stream of receivables is often generated by *ijaras*, the Islamic equivalent of a lease, whose periodic revenue will be the commercial profit paid to the sukuk holders. However, there can be other sources of period revenue underpinning a particular sukuk structure, e.g., income from trade finance transactions, equity investments. Sovereigns may also have at their disposal other types of revenues with the required commercial and sharia-compliant characteristics. In one instance a sovereign used the income from redeemed railway vouchers available to its citizens as the relevant receivables.

(iii) The receivables need to be collected and ring-fenced to be exclusively available to the sukuk-holders. This is done through the establishment of an appropriate special purpose vehicle (an SPV) in a suitable jurisdiction. The SPV issues the sukuks to investors, collects the principal amount from the subscription price, uses it to purchase the income producing assets from the originator of these assets and then manages the assets and the receivables generated by them to service its obligations under the sukuk to the holders.

(iv) The requirement for one or more underlying assets generating receivables to service the payment obligations of sukuk holders, the origination of these assets and receivables from [mostly] one originator, and the ring-fencing SPV structure, make sukuks very similar to securitisations.

(v) Sukuks are traded in secondary markets because a sukuk is a negotiable instrument with the holder having all the rights and obligations of the original subscriber.

(vi) All of these features make sukuks an Islamic law compliant instrument equivalent to a bond.

(b) **Types of sukuk by governing law**. Sukuks issued in global capital markets have been predominantly structured as trust certificates, typically governed by English law. Certain civil-law jurisdictions, where trust is not recognised, use the legislation in place for the issuance of asset-backed securities, i.e., their securitisation legislation.[85]

(c) **An example of a sovereign sukuk**. The example of a sukuk set out below is a stylised and condensed summary of a trust certificate structure using an ijara issued by the Pakistan Global Sukuk Programme Company Limited as issuer and trustee and the government of the Islamic Republic of Pakistan (**Pakistan**) supporting the transaction is a number of roles including as obligor. The full details are availed in the Offering Circular dated 18 January 2022.[86] and publicly available through the London Stock Exchange's website here.

(i) The issuer is a special purpose Pakistani company (the **Trustee**). The Trustee issues the sukuk certificates (the **Certificates**) to investors (the **Investors**) who subscribe for them for cash.

(ii) The Trustee applies the subscription cash proceeds to purchase from the National Highway Authority of Pakistan certain real estate assets (the **Assets**) and pays them to, or to the order of, the National Highway Authority of Pakistan.

(iii) The Assets are then leased (the **Lease Assets**) to the Government of Pakistan (**Government**) who in return agrees to pay periodic rentals for the Lease Assets (**Rentals**).

(iv) The Government also agrees to act as servicer of the Lease Assets for which it receives a service fee (the **Service Fee**).

(v) The Government also grants an undertaking to the Trustee and retains the right to purchase the Lease Assets from the Trustee (the **Purchase Undertaking**) on the occurrence of certain events for a pre-agreed price (the **Exercise Price**). The Government can take the assets itself or can nominate another party, e.g., the National Highway Authority. The Purchase Undertaking also addresses some further matters such as the option to substitute the Lease Assets if required. The undertaking to purchase ensures that the Trustee will always have a principal amount (i.e., the Exercise Price) to receive for the Lease Assets. The Government's right to purchase the Lease Assets means that the Lease Assets are not themselves available to the Trustee (and hence the Investors) putting all the recourse solely on the Government.

(vi) The Trustee uses the Rentals and the Exercise Price to cover its expenses, including paying the Service Fee, and then make periodic distributions to the Investors, including a final distribution amount after which it will be dissolved.

(vii) The Trustee holds certain of its assets on trust for the benefit of the Investors. These include subscription cash proceeds, pending their agreed application, the Trustee's rights to the Lease Assets and the documents of the transaction, and any money in the Trustee's main transaction account.

(viii) The Government (i.e., the sovereign) plays a number of roles in this transaction and is the effective credit for the Investors since it provides the periodic cash-flow, the Rentals, (equivalent to coupon payments in bonds) and the principal amount, the Exercise Price, (equivalent to the principal redemption amount in bonds).

(d) The following structure diagram appears on page 48 of the Offering Circular.

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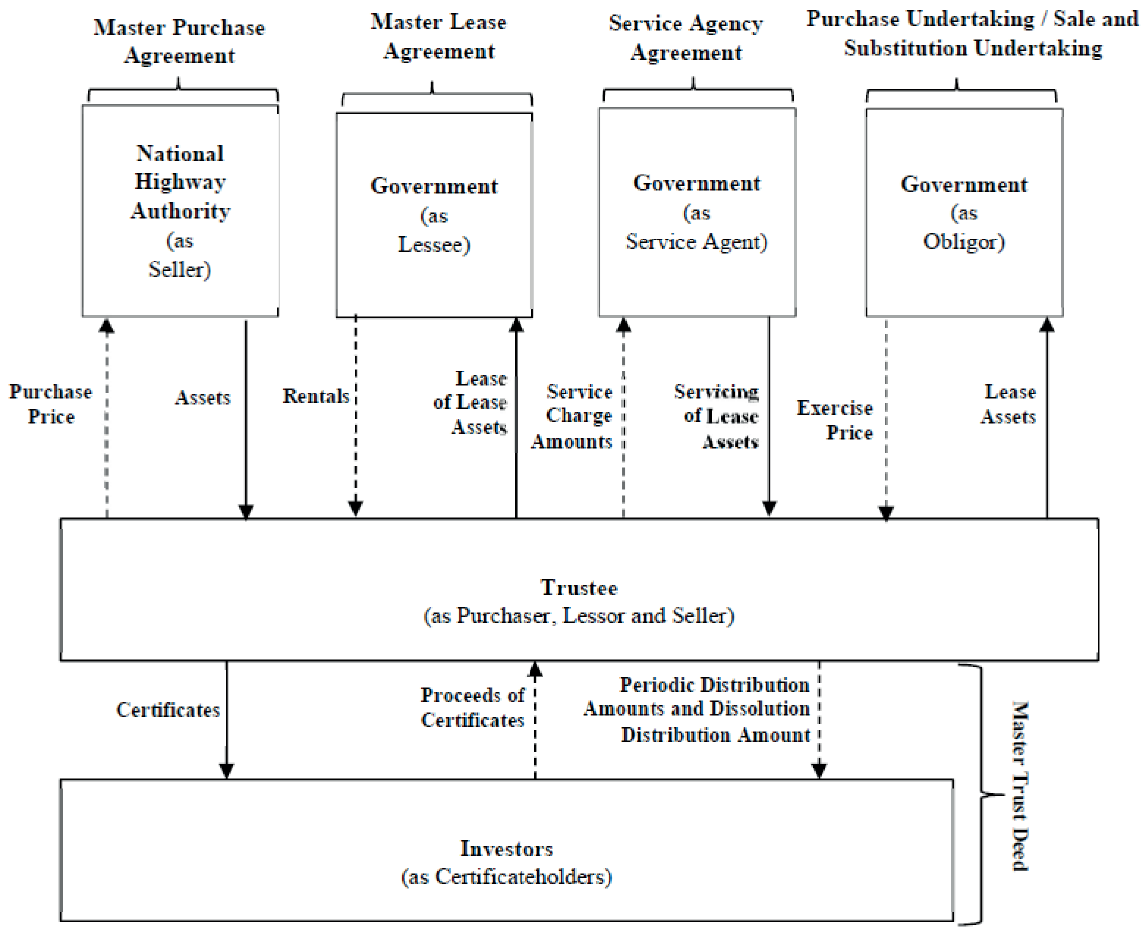
85 *Some civil law jurisdictions such as Turkey, have introduced special legislation to facilitate sukuk issuance.*

86 *See The Pakistan Global Sukuk Programme Company Limited's Trust Certificate Issuance Programme Offering Circular dated 18 January 2022 publicly available through the London Stock Exchange's website* here.

Structure Diagram



(e) Types of sukuk by type of recourse: asset-based vs asset-backed sukuks

(i) Sukuks can be structured in two different ways. One is an <u>asset-based sukuk</u> of which Pakistan's issuance is an example and which is the one used by sovereigns. In asset-based sukuks, investors rely on the credit strength of the sovereign/obligor (see (c)(viii) above) rather than the underlying assets. The structure makes the assets used irrelevant for the investors since the structure ensures that there is never recourse to the assets themselves but only to the sovereign/obligor. Beyond ensuring that the assets used are sharia-compliant and ensuring that the obligor's payment obligation stands in all circumstances, investors do not need to do any further diligence on the assets and their performance.

(ii) <u>Asset-backed sukuks</u> on the other hand depend on the profit/revenue and return of capital/principal amount invested on the assets themselves. In an asset-backed sukuk the originator might be the servicer but there would be no recourse to it if the assets do not generate the anticipated revenues or if they decline in value. This makes asset-backed sukuks very much like asset-backed securitisations.

3. MULTIPLICITY OF INSTRUMENTS AND INVESTORS - UNITY OF MANAGEMENT

3.1 Opening of new markets & seeking new investors – the challenges

(f) Officials may very much want to broaden their investor base, open new markets and find new and more attractive opportunities to sell the sovereign's debt. However, multiplicity of debt instruments and investors brings its own debt management challenges. Who are these new investors and how co-operative will they be if the sovereign needs to make adjustments to its debt obligations? How will these instruments fit with the sovereign's existing debt stock?

(g) The opening up of a parallel bond market, the sukuk market, makes these questions pressing. Having suffered a collective shock with the Argentina litigation where a small group of holders of Argentinean bonds held to ransom all of Argentina, the world's payment system and the remaining majority bondholders, the world of sovereign debt thought it had resolved this difficulty through the introduction of the aggregating collective action clauses (**CACs**).[87] Will the raising of funds through this new instrument fragment the sovereign's creditors, just as tools were being introduced to bring them together?

3.2 The achievement and unfinished job of CACs

(a) The story of CACs, of aggregating CACs, of their merits and indeed of the merits of other mechanisms incorporated in the debt instruments which facilitate the resolution of issues based on majority decisions binding on the minority has been told already many times.[88] In brief, CACs introduce a creditor democracy for each bond issue (also called a single series of bonds). Ordinary matters concerning the terms of the bonds and their administration can be put to a vote determined by simple majority. 50%+ of the bondholders by value. Extraordinary matters are determined by a super-majority of 75% of the bondholders by value. A number of steps have to be followed to convene meetings determine whether they are quorate, and, depending on the documentation, there may be other steps to be taken, but "simple majority for ordinary matters and super-majority for extraordinary matters by reference to principal amounts held by bondholders" remains the fundamental premise.[89]

(b) Aggregating CACs take the creditor democracy a bit further. One could say that they introduce a "debtor's parliament" or "sets of parliaments" within which all invited creditors can vote together or within their debtor-selected groups. This enables the sovereign debtor, issuer of many series of bonds, to bring together the bondholders of all series into one voting group (a "single parliament") or the bondholders of debtor-selected sets of series each into their own single voting group (the "sets of parliaments").[90] The fundamental principle of "simple majority for ordinary matters and super-majority for extraordinary matters by reference to principal amounts held by bondholders" remains here as well. The mechanics have all been worked out and ICMA has published standard clauses for bonds governed by New York and English

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87 *See 4.2(g) and 4.3 of the Chapter One above.*

88 *See Strengthening the Contractual Framework to address Collective Action Problems in Sovereign Debt Restructuring, IMF, October 2014 (here); Strengthening collective action clauses: catalysing change—the back story, Mark Sobel, Capital Markets Law Journal, Volume 11, Issue 1, January 2016, Pages 3–11 (here), Collective action clauses: how the Argentina litigation changed the sovereign debt markets, Antonia E. Stolper, Sean Dougherty, Capital Markets Law Journal, Volume 12, Issue 2, April 2017, Pages 239–252 (here and here).*

89 *Officials should of course pay a lot of attention on all the procedural matters, because their details may, in certain circumstances, be vital to the interests of the sovereign.*

90 *Aggregating CACs offer even greater flexibility to the sovereign bond issuer on how to call for votes. The three-line summary refers to the "single-limb" option of voting, where the pools of the aggregated series vote as one. A "two limb option" is also available – for a thorough explanation of the technical features of CACs see New ICMA sovereign collective action and pari passu clauses, Clifford Chance, October 2014 (here).*

law, the two legal systems most likely to be acceptable to investors for foreign currency bond issues.[91]

(c) Adding sukuks to the mix raises two challenges. First, the challenge of different governing laws. Aggregating CACs have been proposed on the fundamental assumption that all the bonds of a sovereign issuer are likely to be governed by one of the two external systems of law, New York or English law. The assumption is reasonable from a practical perspective, but the question of how to resolve a possible conflict of laws when aggregating a mix of New York <u>and</u> English law sovereign bonds is, as yet, practically unanswered. Sukuks have, so far, been exclusively an English law debt instrument. Their aggregation with any New York law bonds will be a new challenge and will require a practical and a legal answer.

(d) The second challenge concerns the mechanics of aggregation of conventional bonds and sukuks even if they are governed by the same law. Bonds are issued by the sovereign. Each sukuk is issued by a different SPV. The ICMA English law model aggregating CACs are drafted only with "debt securities issued by the same issuer" in mind.

*(ix) Any reference to "**debt securities**" means any notes (including the Notes), bonds, debentures <u>or other debt securities issued by the Issuer</u> in one or more series with an original stated maturity of more than one year.*

*(x) "**Debt Securities Capable of Aggregation**" means <u>those debt securities which include</u> or incorporate by reference this Condition [•] (Meetings of Noteholders; Written Resolutions) and Condition [•] (Aggregation Agent; Aggregation Procedures) or provisions substantially in these terms which provide for the <u>debt securities</u> which include such provisions to be capable of being aggregated for voting purposes with other series of <u>debt securities</u>.*[92]

(e) How to aggregate securities and place them for a common vote if they have not been issued by the same person – even if they have the same governing law? To achieve this each securities issue intended to be aggregated with others ought to have the appropriate aggregating provisions.

(f) The securities issued by Pakistan provide such a contract design solution. Here are the provisions from Pakistan's issue of sukuk certificates discussed above[93] and from its Global Medium Term Note Programme (**GMTN**) as they appear in its Offering Circular dated 29 March 2021[94] **GMTN"**

(g) (i) Any reference to debt securities means any notes (including the Notes), bonds, debentures or other debt securities (which for these purposes shall be deemed to include any sukuk or other trust certificates representing the credit of the Issuer) issued directly or indirectly by the Issuer in one or more series with an original stated maturity of more than one year.

(i) (j) Debt Securities Capable of Aggregation means those debt securities which include or incorporate by reference this Condition 15 and Condition 16 or provisions substantially in these terms which provide for the debt securities which include such provisions to be capable of being aggregated for voting purposes with other series of debt securities.

The "Issuer" in the GMTN is the Islamic Republic of Pakistan. "[D]ebt securities" include "any sukuk or other trust certificates representing the credit of the Issuer … issued directly or indirectly by the Issuer". The definition therefore includes securities like the asset-based trust certificates issued by the SPV but where investors rely on the credit of the "Issuer"/Pakistan.

These provisions are necessary for aggregation, but, on their own, not sufficient. The sukuk provisions must achieve the same end.

91 See ICMA's webpage <u>here</u> and Clifford Chance op.cit.

92 See ICMA op.cit.

93 See 2.3(c).

94 See the Islamic Republic of Pakistan's Offering Circular for Global Medium Term Note Programme dated 29 March 2021 publicly available through the London Stock Exchange's website <u>here</u>.

3.3 Sukuk

(ii) Any reference to securities means any trust certificates (including the Certificates), bonds, debentures or other securities (which for these purposes shall be deemed to include any sukuk or other trust certificates representing the credit of the Government) issued directly or indirectly by the Trustee or the Government, as the case may be, in one or more series with an original stated maturity of more than one year.

(iii) Securities Capable of Aggregation means those securities which include or incorporate by reference this Condition 15 and Condition 16 or provisions substantially in these terms which provide for the securities which include such provisions to be capable of being aggregated for voting purposes with other series of securities.

The issuer here is the SPV/"Trustee" and the "Government" is the government representing Pakistan, i.e., the sovereign. The "securities" include other "any sukuk or other trust certificates representing the credit of the Issuer … issued directly or indirectly by the Trustee or the Government". The definition therefore includes securities like the bonds issued under the GMTN as well as other sukuks issued by the same or other trustee where investors rely on the credit of the "Issuer"/Pakistan.

The contract design gives Pakistan the flexibility to aggregate its securities as it considers appropriate and hence convene for each decision the appropriate "parliament of creditors".

4. TAKEAWAYS FOR OFFICIALS.

In addition to the overall considerations discussed in Chapter One above, Officials contemplating entering into an Islamic finance transaction should remember the following key takeaways.

(a) Have any legal uncertainties on the structure of the proposed Islamic finance transaction been eliminated and appropriate confirmation received by the relevant Sharia experts?

(b) As much as Islamic finance instruments may seek to replicate conventional debt instruments, they are not intended at their core to be debt instruments. The core of all these instruments is a Sharia-permissible commercial activity which generates cash-flows in a manner which mimics the debt instruments. But whereas conventional debt instruments all rely the use of money and a return on it over time, Islamic debt instruments rely on appropriate commercial transactions. This means that each Islamic debt instrument adopted must be examined for any collateral implications it may have as a result of the underlying commercial transaction. These collateral implications cover a broad range of topics. Each one of these risks may affect the aggregate financing costs of the transaction and since in most cases investors will want to hold the equivalent of a bond or a loan, the burden and cost of these risks is likely to fall on the sovereign. Each transaction should therefore be analysed both as a finance and as a commercial transaction. Examples of such risks are:

(i) Is the transaction taxable or subject to duties and who bears the risk?

(ii) Is any insurance required and, if so, how can this be arranged in a Sharia-compliant way? Who bears the risks and costs?

(iii) Are any permits or registrations required for the use of the relevant assets?

(iv) Are there any uninsurable risks associated with the underlying commercial transaction and who bears them?

(c) If any modification of the arrangements is required (whether it is a waiver, a simple amendment or a complete restructuring in the context of debt distress):

(i) Does the contractual mechanism permit such modification?

(ii) How easily do the modification mechanics work?

(iii) Consent issues.

(A) Whose consent is required?

(B) Are there many types of possible

stakeholders whose consent is required or is it just the investors?

(C) Are they known with an on-going relationship or anonymous stakeholders?

(D) Can the modification be effected with some sort of majority which binds the minority? Are there entrenched minority rights?

PART 2 BANK BORROWING

1. BACKGROUND – BANK LENDING IN AFRICA

(a) Bank lending continues to be important for African sovereigns even for those that have access to the capital markets. The author has not been able to find exact data for all of Africa, but individual country numbers can be gleaned from the databases maintained by the World Bank and show that bank lending is still important.[95] Bank lending remains strong from official bilateral lenders and various policy and commercial banks of creditor countries such as China, Saudi Arabia, India, UAE and others.

(b) Of these lenders and their loans, the ones from China have attracted a lot of attention, mostly because of their overall size and extent, but also because of geopolitical debates. According to the sources, between 2000 and 2020 over US$159 billion has been lent by Chinese lenders to African countries through over 1,180 loans.[96] The CARI database breaks down these loans by type (transport, power, mining, information and communication technology, water, social projects, industry, defense, etc.) and country (with all countries other than Somalia, Libya and West Sahara having borrowed).

(c) The amount, range and (until the last few years) rapid increase of Chinese lending coincided with a decline of lending from Western lenders, a decline which became steeper after the 2008 Financial Crisis. This resulted in Chinese lending's increased special gravity in almost all debtor countries. It is this increased special gravity that has given rise to the geopolitical debates. In addition, trade and geopolitical competition between China and the West have spilled over on lending practices. The strategic and commercial importance of several of the traded (and financed by Chinese lenders) commodities magnifies the competition. For the purposes of this handbook and for the purposes of Officials considering loans, these debates will be ignored. The focus will remain on certain terms of all loans, not only of Chinese ones, and what these terms might mean for the sovereign and Officials acting on its behalf.

(d) Given the continuous importance of loans for African sovereigns, Officials should be interested in how to tap these available credits, how to mobilise them to grow their economy and how to negotiate appropriate terms for them.

2. THE TWO PRINCIPLES – THE DISCUSSION IN CHAPTER ONE

(a) Officials should recall the two principles identified at the outset of this handbook earlier: [97]

(i) "*How to account for a [non-traditional] debt instrument, how to incorporate it in the cash-flow and the debt sustainability models and how to approach its non-financial*

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95 *See World Bank International Debt Statistics (here). See here for an example of the detailed numbers available for Ethiopia – the "Country" drop-down menu allows the selection of any other country and the "Counterpart – Area" drop-down menu can show all creditors ("World") or specific creditors.*

96 *Data on these have been compiled by CARI, the China Africa Research Initiative at Johns Hopkins University's School of Advanced International Studies (here) and the CARI loans database (here). The site has a wealth of other information and commentary and is not limited to Chinese loans to Africa, but also other investment, aid, trade, debt relief etc. The maintenance of the databases has recently been transferred to GDP, the Global Development Policy Center at the Pardee School of Global Studies of Boston University (here). The Global Development Policy Center has a more general Global China Initiative to promote policy-oriented research on China's overseas economic activity and engagement with international institutions (here) which also has a wealth of other information and commentary on the topic.*

97 *See Chapter One, paragraph 2.4(b) and paragraph 2.5(h).*

provisions"; and

(ii) "*How to ensure that any future resolution of the collective action problem is resolved and resolved optimally*".

(b) Officials should also recall and review sections 3 (The basic features of debt instruments) and 4 (Expanding the two principles – identifying key features – raising questions) of Chapter One. Section 3 sets out the types of provisions which may be present in a debt instrument, including in any loan agreement. Section 4 considers the two principles in the context of overall debt management and by reference to a debt instrument's types of provisions. The rest of this section will focus on some selective issues which come up in loan agreement discussions. Inevitably, some of the discussion here will overlap with that of sections 3 and 4 of Chapter One.

3. LOAN FLEXIBILITY MAKES IT "NON-TRADITIONAL"

(a) The detailed terms of loans raised by African sovereigns is not known, except in limited circumstances.[98] Even where terms are known, it is difficult to conclude much about the loans whose terms are not disclosed. By their very nature, loans are intended to be flexible and customised to the needs of the particular borrower, lending purpose and type of lender. This makes loans both "traditional", in a very generic sense, and "non-traditional", in the sense that they can always contain novel clauses.

(b) Loans are always more bespoke, more drafted to suit the occasion of the particular financing and the individual identities of the contracting parties than the closest comparable debt instrument, bonds. Notwithstanding the recommended standardisation of a number of loan provisions,[99] an on-going project especially in relation to sovereigns,[100] loans remain flexible and capable of fitting the particular circumstances. Unlike bonds they are not traded easily, their financing purpose is usually more specific, their Representations and Covenants Provisions more detailed to tie-in to the financing purpose, their Default Provisions broader in scope, principally aiming to anticipate crises but also as a last resort terminating the financing, and their Administrative Provisions drafted to suit the individual nature of the contracting parties.[101] Having considered in Chapter One the key considerations for these provisions, in this section we will briefly discuss the standardisation efforts, and then a few more specific provisions which will always be important for Officials.

4. STRIVING FOR STANDARISATION

(a) The effort to standardise loan provisions has been an on-going project long before the establishment of the LMA and LSTA. The approach to standardisation had always been non-prescriptive, i.e., not to dictate what terms parties should use. After all, as with all contracts, parties can themselves decide what to include and how to draft their clauses so as best to protect their interests and provide such clarity to the mutual end aspired by the contract as they thought appropriate. A prescriptive approach would, therefore, be more irrelevant than counterproductive. Rather the approach was to look at recurring challenges and debates on a core number of

98 *African sovereigns do not all maintain public databases with details of their borrowing terms. We get a glimpse of the terms of Chinese loan agreements from a recent study which reviewed 100 such loan agreements. See How China Lends: A Rare Look into 100 Debt Contracts with Foreign Governments, March 2021, by Anna Gelpern, Georgetown Law and Peterson Institute for International Economics, Sebastian Horn Kiel Institute for the World Economy, Scott Morris Center for Global Development, Brad Parks AidData, William and Mary, and Center for Global Development and Christoph Trebesch Kiel Institute, Kiel University and CEPR (here).*

99 *See the websites of the LMA, LSTA, and ACT op.cit., footnote 19.*

100 *See ICMA publishes new majority voting clauses for commercial loans to sovereign borrowers to facilitate sovereign debt restructuring (here).*

101 *See Chapter One sections 3 (The basic features of debt instruments4 (Expanding the two principles –identifying key features – raising questions.*

issues and bit by bit build on any emerging market and best-practice consensus was emerging.

(b) The goal was, and remains, to propose standardised language for certain provisions following a discussion among stakeholders and practitioners on the basis of an emerging market consensus. Standardisation promises greater certainty as all parties agree on the meaning of clauses, or at least believe they do. Standardisation following such market acceptance and detailed work by leading market participants and advisors makes provisions conventional. This in turn makes it easier for parties to agree and finalise transactions. Standardisation helps to minimise negotiation times and reduces transaction costs. Standardisation of this type makes loan agreements more “traditional”.

(c) However, as markets evolve and as common understanding on some provisions turns out to have been illusory or ill-founded, the common ground gets revisited, and the standardised clauses get updated or replaced. The evolution of the leveraged loan markets and the subsequent evolution of the LMA and LSTA forms are such a general market example. The replacement of LIBOR is a specific example. The *pari passu* clause is an example of ill-founded common understanding, though not so much in the loan as in the bond market. Standardisation is a never-ending task. The process almost always and inevitably raises anew the questions already considered earlier.

(d) Standardisation of loan agreements organised around market bodies has made great strides in the corporate debt markets. Less so in the sovereign debt markets for a variety of reasons which are beyond the scope of this handbook. Most recently, under the call of the IMF[102], the UK Treasury, as then then G7 co-ordinator, after consultations with debtors and creditors, proposed a number of standardised provisions for syndicated loans to sovereigns, principally on voting provisions. The approach was different to that followed by the LMA and LSTA. There was no general market consensus or even major market dysfunctionality which required a prescriptive consensus. The proposals were driven by policy concerns. With the onset of the pandemic there were fears that the weaker sovereigns would be facing debt distress, and that the resolution of the debt distress would be exacerbated if syndicated loans did not have [super] majority voting provisions for amendments & waivers relating to, among others, amounts due and the payment dates of these amounts as bonds do (the **MVPs**). These MVPs are intended to replace existing amendment and waiver provisions which require unanimous creditor approval to be accepted. The replacement of unanimity by a super-majority is intended to mirror CACs in bonds where an enhanced majority can bind a dissenting minority. This major policy proposal from unanimity to [super] majority was accompanied by (i) provisions to mitigate concerns of creditors, in particular on disclosure and transparency, and (ii) “best practice” provisions common in corporate loan documents which do not always find their way in sovereign loans. The results of this initiative can be found in ICMA’s website[103] and have been commented by industry bodies and practitioners.[104] As a result, they need not be considered in this handbook, except in the context of the discussion on voting, transfers, and default provisions.

5. MAIN QUESTIONS

The questions Officials should consider in relation to any loan are:

(i) Purpose.

(A) What is the purpose of the loan?

(B) How does it fit within the development goals of the sovereign?

(C) How would the financing and the

102 See page 32 of The International Architecture for Resolving Sovereign Debt Involving Private-Sector Creditors—Recent Developments, Challenges, and Reform Options (here), 1 October 2020.

103 See footnote 101.

104 See IIF’s Guidance and Explanatory Note – Majority Voting Provisions (here) and Clifford Chance’s Majority Voting for Payment Term Amendments in Sovereign Loans (here and here).

application and use of the amounts borrowed affect the sovereign's debt sustainability?

(ii) Suitability.

(A) Is a loan of the type offered the most appropriate debt instrument to finance the purpose?

(B) If other instruments are also available and the pricing is comparable, what is the rationale for choosing a loan (over, for example, a bond)?

(iii) Approval.

(A) Who has power and authority to authorise the loan arrangements?

(B) What specific steps and authorisations are required and how long will they take?

(iv) Accounting, recording, disclosure – Confidentiality Provisions.

(A) How is the loan to be recorded, accounted for and disclosed to the appropriate audiences?

(B) How is the approval of the loan going to be disclosed to the appropriate audiences?

(C) Do the Confidentiality Provisions conflict with the accounting, recording and disclosure policies of the sovereign?

(v) Rule book, referee and immunity.[105] What are Governing Law, Forum/Tribunal and Immunity Provisions? If external:

(A) Is the governing law one which has principles and jurisprudence sophisticated enough:

I. to allow the parties to rely on their certainty and applicability;

II. to give effect to the provisions as intended by the parties; and

III. to be capable of providing an appropriate resolution to a dispute?

(B) Are the judges/arbitrators adjudicating over a likely dispute in the forum ones with appropriate experience, capability and detachment to ensure an outcome which will not be just formally final, but which, if known to both parties *ex ante*, would have been acceptable to them?

(C) Are the combined governing law and dispute resolution provisions such that they can permit the parties to resolve disagreements with appropriate certainty and finality without necessarily resorting to formal dispute resolution proceedings?

(D) Are the immunity provisions set by the governing law ones which permit the sovereign to waive all of them in advance ("selective immunity") or do they commit the creditor to seek fresh waivers at each of the submission to jurisdiction, judgment recognition and judgment enforcement steps ("absolute immunity")? What is the overall negotiating balance if the applicable immunity rules are "absolute"?

(vi) Cash-Flow Provisions.

(A) What are the pure debt terms, the Cash-Flow Provisions offered?

(B) What other provisions are there which may vary the sovereign's payment obligations during the term of the loan and on the basis of what adverse contingencies?

I. How well defined are these contingencies?

II. Who determines if these contingencies have occurred?

III. Have these contingencies been

105 *For the importance that choice of governing law and forum play see Governing Law Risks in International Business Transactions, by Philip Wood, Oxford University Press, December 2022.*

modelled and understood in the context of the overall purpose and suitability of the loan arrangements?

(vii) Payments.

(A) Where are payments made and when is a payment obligation discharged?

(B) Can the payments be made through the sovereign's central bank? Would this be sufficient to insulate the sovereign from an injunction as the one in the Argentina litigation which affected the global payments system? Would creditors be prepared to accept this – would they still be able to exercise their legitimate rights at a time of a crisis?

(viii) Information Covenants.

(A) What is the ongoing information which the sovereign will be asked to provide through its Information Covenants?

(B) Is any information required on relevant economic data (e.g., total central government debt, gross financing needs, GDP, GDP/PPP, forex reserves, fiscal and trade balances and forex elements in them, revenue collections) (**Economic Data**) to be prepared in accordance with appropriate international and IMF/WB approved standards?

(C) Can this information be provided to the standards and time limits required?

(D) Is this information provided equally to all other creditors, or are there information asymmetries with adverse effects on intercreditor equity and potential market abuse issues?

(ix) Negative Pledge.

(A) Overall, how appropriate is the provision? Is the negative pledge consistent with the sovereign's overall policy on secured debt, on maintaining a level playing field for its creditors and respecting intercreditor equity?

(B) What is the relevant debt over which the provisions apply, i.e., the debt over which security may not be granted? Is this consistent with the overall debt policies of the sovereign and with the type of debt it intends to incur?

(C) How is prohibited "security" defined? Both formal/*de jure* and quasi-security?

(D) Are there legitimate and appropriate carve-outs for "permitted security"? What would these include? How do they fit within the sovereign's overall economic development programme?

(x) Security.

(A) If there is any security offered over cash balances or receivables:

I. are these cash balances/receivables collected in a domestic or overseas account?

II. is there formal/*de jure* security over these cash balances/receivables?

III. can the creditor apply self-help over these cash balances/receivables, e.g., by way of set-off?

IV. how will the security be affected if, in a situation of debt distress, the sovereign declares a moratorium?

(B) Is any security offered in breach of negative pledge provisions in other debt instruments? In particular, is it in breach of any World Bank negative pledge or similar which would prevent the sovereign from raising long term funds at appropriate rates?

(C) Is any security offered in such terms that might make an IMF program impossible or very difficult in times of crisis?[106]

(xi) Asset Management. Does the loan agreement contain any restrictions on

106 *See discussion in Schedule 1Part 2 What is Commodity-Backed Finance?*

asset disposal or more broadly anything which could restrict the sovereign's ability to manage and develop its assets whether by means of a state-planned or market/ privatisation programme?

(xii) Financial Covenants. Are there any covenants which require the sovereign debtor not only to report on relevant Economic Data, but also to comply with any covenants set on them? If so, is this appropriate or relevant? What are the consequences of non-compliance?

(xiii) Other covenants. Are there any other covenants? If so:

(A) Do they confer a substantive and legitimate right to the creditors? How is its substance and legitimacy assessed?

(B) Do they restrict the sovereign in the conduct of its policies or in the administration of the country? If they do:

I. is it strictly within legitimate confines which seek to protect the purpose of the loan and the use of proceeds; and

II. is it by means which are consistent with the overall exercise of sovereignty by the sovereign?

(xiv) Administrative Provisions.

(A) How do the various Administrative Provisions fit with other debt arrangements of the sovereign? Do they fit with its "middle" and "back-office" operations?

(B) How well can the day-to-day matters of this debt arrangement be monitored?

(C) Do any of the Confidentiality Provisions interfere with the sovereign's debt management?

(xv) Amendments and Waivers Provisions.

(A) What provisions can be amended/ waived and with what majorities? Does this provide sufficient flexibility during the term of the loan?

(B) What provisions require unanimity?

I. How would the creditors respond to a request for the inclusion of the MVPs promulgated by the IMF/G7/ HMT?

II. Is such a request likely to result in the break-up of the syndicate and in more bilateral loans?

III. Are any safeguards proposed by the lenders appropriate and capable of being satisfied?

(C) How do these provisions tie up with the ability of the sovereign to approve new creditors or to remove them (see below)?

(xvi) Party Identity and Changes Provisions.

(A) What are the Party Identity and Changes Provisions? Does the sovereign have control over the identity of creditors? Are there limits to such control?

(B) Who bears the credit and funding risk? The lenders of record or a host of sub-participants? If the latter:

I. how transparent are the credit support arrangements?

II. are these arrangements in respect of both risk and funding, or only in respect of risk? If in respect of risk only, what is the trigger for the risk transfer?

III. how easily can the sovereign engage with these sub-participants?

IV. is it possible to bring these sub-participants as direct participating lenders if this is to facilitate engagement with them, especially during a debt distress situation?

(C) Are there any provisions which entitle the sovereign debtor unilaterally to remove creditors on condition of prepayment just to them? Are all the relevant conditions for such a right considered (e.g., if the particular creditor's participation results in increased costs or taxes, or if it refuses to consent to requests for specified amendments/waivers)?

(D) If the sovereign finds itself in debt distress:

I. will the sovereign be able to engage with the persons who bear the credit and funding risks?

II. how are the creditors likely to engage? Are they likely to be part of the core, long-term investors in the sovereign?

III. what would be the creditor's self-interest and its expectations concerning inter-creditor matters? and

IV. how would the creditor's capital and funding costs constrain its ability to engage?

(xvii) Default Provisions. Default Provisions in sovereign loans agreements will almost always depend on the purpose of the loan. It is expected that some Default Provisions will always be there regardless of purpose. To determine what is legitimate for the creditor to request it is important (I) to distinguish between ordinary times and distress times and (II) to remember that in distress times the nature of a sovereign as special debtor changes the dynamic between debtor and creditor in a very radical way.[107]

(A) Ordinary times. In ordinary times, certain Default Provisions (as well as certain Representations and Covenants Provisions) will simply act as a reminder and a lever to the sovereign debtor to comply with the agreed terms. For example, it may be that the sovereign has not prepared well or has not delivered on time the statements showing its international monetary assets and external debt. Creditors are likely to rely on the Default Provisions to warn the sovereign of its failure to perform as agreed. At most, if the loan agreement (or debt instrument) entitles them to any additional payments whilst the default is outstanding (e.g., through a step-up margin), they will claim this additional payment. Equally, however, the creditors will be loath to use any of their other, more draconian, remedies (such as accelerating the loan or putting it on demand), knowing that this may precipitate an overall distress situation. To ensure compliance, the creditors will instead rely on the overall pressure this failure will put on the sovereign.

(B) Sovereign in distress. Some Default Provisions such as Non-Payment Defaults and Status Defaults[108] (e.g., declaration of a moratorium, or loss of membership and/or ability to draw funds from the IMF) are likely to signal that the sovereign debtor is in distress. In such a situation overall pressure by non-compliance is meaningless. In times of sovereign distress creditors know that, at best, they may be able to obtain a judgement against the sovereign, but without really being able to enforce. Sovereigns can refuse payment not only without fear of external pressure, but very likely with some approbation for safeguarding assets in preparation for an overall restructuring. Sovereigns also know that in these situations they will never be able to write down the debt unilaterally or through a process not involving the creditors. This ties the sovereign debtor and its creditors in a conflict which can only be resolved through an engagement process and consent.

(C) What do creditors do when

107 *See Chapter One, section 2.5 and in particular 2.5(e).*

108 *See Chapter One, section 3(c)(v).*

sovereigns are in distress? This usually depends on a variety of factors:

I. Creditors who are return players109 and interested in the long term will almost always use the Default Provisions to ensure that engagement occurs. These creditors will include, among others, large banks, smaller banks with domestic presence, large fund managers or specialist hedge funds who see participating in the restructuring as an opportunity to increase their returns.

II. Creditors whose exposures are large, even if they are not return players are also very likely to seek to engage with the debtor and use the Default Provisions accordingly. If the terms of their debt instrument are such that they can operate autonomously they may seek separate engagement, rather than follow the more usual processes where the IMF offers financing and a program in return for official assurances and comparable treatment.

III. Creditors who are small, non-systemic, non-return players, may seek to hold out and demand to be paid in full. They may be able to pursue this strategy either if the terms of their debt instrument allow them, or if they succeed in converting their claim into a judgement debt. In this latter case they will use the Default Provisions to accelerate and enforce.[110] In the context of syndicated loans, the presence of such creditors is rare. Officials should at first instance select syndicate participants Nonetheless, if they are present, they may prevent the majority from reaching an agreement with the sovereign. In such cases, and assuming their participation is not large enough to enable them to block even a majority decision, the proposed MVPs may be the easiest way to bring such non-cooperative creditors to participate.

IV. Very rarely, creditors who seek to engage may use the Default Provisions to accelerate and enforce if failure to do so would risk see their debt extinguished because of a limitation period.[111] These cases are exceptional and there is little planning that Officials or indeed anyone else can do.

(D) What should Officials do? Officials should not consider Default Provisions in isolation. They should consider them together with the Party Identity and Changes Provisions and the Amendments and Waivers Provisions. Even when (i) Officials are satisfied with the identity of their creditors and (ii) the creditors have accepted MVPs, Officials should still review the Default Provisions with great care but also with an understanding of the legitimate interests of the creditors.

(xviii) **General**. Are there any other provisions in the loan agreement which make the lending unusual or onerous?

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109 See footnote 30.

110 This is what NML did in the Argentina restructuring and what Hamilton Reserve Bank is currently attempting in the Sri Lanka restructuring.

111 This is what the lenders of record had to do in the case of Sudan, when certainty on the validity of the agreement acknowledging the debt before the end of the limitation period was vitiated by the ongoing civil conflict. More crucially, this is what some may have to do in the case of Venezuela, given the difficulties in reaching debt acknowledgement agreements because of sanctions.

PART 3 PLURILATERAL LENDERS

(a) **What are plurilaterals?** As noted at the outset, African sovereigns are likely to borrow funds through loans from a range of lenders. Sitting between the multilateral development banks and the countries lending on an official bilateral basis sits a different category of lenders, the so called "Plurilaterals" of "IFIs". The classification comes from the IMF. The IMF criterion for being "a 'multilateral' is based on a judgment informed by factors including global membership, and treatment by the Paris Club and under the Heavily Indebted Poor Countries (HIPC) Initiative"[112]. "Plurilateral institutions are defined as those creditors composed of two or more official creditors [(and no non-sovereign member)][113] which do not meet the multilateral criteria".[114]

(b) Why does it matter? The IMF classification is in the context of its No Toleration of Arrears Policy, namely the policy that requires, among others, that it itself, the World Bank and certain other "multilateral lenders" always be paid in full at the time of a sovereign debt restructuring. Given the "preferred creditor status" afforded to multilaterals, the classification is very important when it comes to debt restructuring because it affects the perimeter of the debt to be restructured. According to this classification plurilaterals fall in the category of "official bilateral lender", a class of creditors which does participate in the debt restructuring.

. Do plurilaterals always participate in the restructuring? Plurilaterals believe they are "multilaterals" and as such should enjoy preferred creditor status. Although the IMF's starting position is that plurilaterals are official bilateral lenders and not multilaterals, the IMF does apply a set of criteria for "upgrading" plurilaterals to multilaterals.[115] These criteria are applied by reference to facts reducing their predictability and could skew the dynamics and the conversations and pressures at the time of restructurings.

(a) Regional nature of plurilaterals. Plurilaterals tend to be formed by a few sovereigns either on a regional basis or on a political alliance basis. So even if they are not upgraded to "multilaterals", the sovereign debtor may be under unusual pressure in fact to exclude them from the perimeter of debt to be restructured. This is what the European Investment Bank (classified by the IMF as a plurilateral) achieved at the time of the Greek debt restructuring.

(b) Lending terms of plurilaterals. Plurilaterals lend through loans and hence the considerations set out elsewhere in this handbook on lending provisions of debt instruments and loans in particular will apply to the loans by plurilaterals. In addition, some plurilaterals will use unusual terms, because these have been agreed in their founding charters. For example, the loans of the New Development Bank are governed by "public international law" and are subject to arbitration in one of the founding countries. Moreover, some plurilaterals lend on concessional terms (e.g., Arab Bank for Economic Development in Africa, European Investment Bank, OPEC

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112 *See the IMF's policy paper Reviews of the Fund's Sovereign Arrears Policies and Perimeter, 23 May 2022 (here and here) which considers both multilaterals and "plurilaterals" or, as they are referred to in this paper "IFIs".*

113 *This phrase appears in the IMF's policy paper Reviews of the Fund's Sovereign Arrears Policies and Perimeter, above.*

114 *See the IMF's Guidance Note on Implementing the Debt Limits Policy in Fund-Supported Programs, 29 April 2021 (here).*

115 *See paragraph 58 of the IMF's policy paper Reviews of the Fund's Sovereign Arrears Policies and Perimeter, above.*

Fund for International Development, and Nordic Development Fund) whereas others lend on commercial terms (e.g., Afrieximbank and ESA TDB)[116].

. What should Officials consider? Based on all previous considerations Officials should consider the cost of the borrowing (by reference to alternatives), the likelihood of exclusion from the debt restructuring perimeter in times of debt distress and the specific provisions.

116 *As noted by the IMF in its 2023 Article IV Consultation, First Review Under the Extended Credit Facility Arrangement, and Financing Assurances Review for Zambia, page 55.*

GLOSSARY

Bilateral Swap – a swap between two (sets of) parties, i.e. the debtor and the creditor (or a group of creditors)

Bonds – a tradable financial instrument representing a debt, issued by sovereigns, state-owned enterprises or corporates in the capital markets.

Call Option - an option to buy assets at an agreed price on or before a particular date, which can be included in the terms of a bond.

Carbon Trading - the buying and selling of credits that allow companies or other parties to emit a certain amount of carbon dioxide.

Debt for Education Swap – a project-based swap where the agreed projects / commitments are related to the provision of education or educational infrastructure.

Debt for Health Swap – a project-based swap where the agreed projects / commitments are related to healthcare, vaccines or similar fields.

Debt for Nature Swap – a project-based swap where the agreed projects / commitments are related to conservation or protection of natural or animal life.

DFC – the Development Finance Corporation, a US governmental development finance organisation that has provided support for project-based swaps.

Discounted – debt trading in the secondary market for less than its par value (e.g. 80 cents on the dollar represents a discount of 20 per cent.)

Distressed Debt – the debt of a company or sovereign that may be unable to fulfil its financial obligations.

Intermediary – the "middle" entity in a trilateral swap, a role often performed by an SPV.

Liability Management - a variety of procedures and techniques used by bond issuers for the purposes of buying back, exchanging or altering the terms of bonds

NPV – net present value, meaning the value in the present of a sum of money, in contrast to the future value it will have when it has been invested for a period of time (e.g. if interest rates are 10 per cent., 110 due in 12 months' time has a present value of 100 today).

OFC – Ocean Finance Corporation, a project manager for debt swaps.

Open Market Purchase - the purchase and sale of securities in the open market, as opposed to via tender offer.

Project-Based Swap – a debt swap which includes as a condition for debt relief the performance of specific projects such as sustainability commitments.

Project Manager – entity which arranges and supervises the performance of commitments for project-based swaps.

SPV – special purpose vehicle, meaning a new company incorporated for one specific task in a transaction structure (often used as the intermediary in a trilateral swap)

Sustainability Commitment – the commitments in a debt for nature swap which the debtor agrees to perform in exchange for the debt relief provided.

Tender Offer – a public offer to buy securities (e.g. bonds) from every holder at a certain price at a certain time.

TNC – The Nature Conservancy, a global environmental organisation involved in project managing debt for nature swaps since the 1980s.

Trilateral Swap – a structure of project-based swaps whereby an intermediary buys outstanding debt on a secondary market at discounted rates, funded by an issuance of new guaranteed or insured debt at par value.

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ALSF SOVEREIGN DEBT KNOWLEDGE PRODUCT AND CAPACITY BUILDING PROJECT:

KEY CONSIDERATIONS FOR INCURRING NON-TRADITIONAL DEBT GUIDE

African Legal Support Facility I Facilité africaine de soutien juridique
Immeuble du Centre de commerce International d'Abidjan CCIA,
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