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AFRICAN LEGAL SUPPORT FACILITY | FACILITÉ AFRICAINE DE SOUTIEN JURIDIQUE

# Understanding Sovereign Debt

## Options and Opportunities for Africa

2nd Edition

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# Contents

# Foreword

For the last five decades, the debt sustainability of African countries has been a constant and, at times, controversial topic of discussion. The issues around Africa's debt are indeed unique but in today's global world, concerns about a country's economic vulnerabilities remain universal. One of the primary reasons for the establishment of the African Legal Support Facility (ALSF) was to support African states in avoiding the pitfalls of excessive debt accumulation. The promotion of sound sovereign debt management and the quick resolution of distress situations are essential to Africa's economic growth while being beneficial to the stability of the global economy.

In 2019, the ALSF gathered world-leading experts to develop a handbook dedicated to African debt managers and other government officials involved with sovereign debt. The overall objective was to strengthen institutional capacity by demystifying the complexities surrounding this fundamental area of economic development and enabling the quick identification of salient issues. The resulting handbook, "Understanding Sovereign Debt — Options and Opportunities for Africa", received widespread acclaim and its text was adopted by the primary target audience and by practitioners, academics and civil society. Although the ALSF created it with African governments in mind, the handbook's content proved to provide valuable knowledge and insights for the general public beyond the Continent.

Five years on, the world has undergone seismic shocks including the COVID-19 global pandemic, several armed conflicts including the first European war post WWII and the escalating impact of climate change. Reduced concessional lending, slowing economic growth, volatile commodity prices, exchange rates depreciations and the rapid rise in expenditures have all contributed to a sharp increase in public indebtedness across the Continent. African states are reeling from the negative shocks whilst striving to reach their development goals.

As debates around debt restructuring, climate financing and the scramble for new financing continue, the ALSF recently reconvened its task force of world-leading experts with additional new voices to update this important handbook. The ALSF hopes that a renewed handbook on sovereign debt management can empower African sovereigns to make informed, strategic decisions in their sovereign debt financing operations.

This update also stems from the feedback of its current users and the recent developments that its authors have observed. It intends to challenge the lexicon and narrative of sovereign debt and align this with the current realities facing debt managers. It also examines the actors filling the gap in financing; identifying areas of caution and analysing the often under-explored dangers that sovereigns in Africa (and beyond) face.

It is important to reiterate that debt is not inherently bad. Sovereign borrowing allows countries to finance much-needed infrastructure projects and social programmes. Its function is critical to enabling countries to succeed in attaining their development goals. Nonetheless, while sovereign debt can be an effective economic growth catalyst, its mismanagement can have the opposite effect, pushing governments into precarious situations with longstanding economic consequences. Developing and implementing sustainable debt strategies and robust debt management frameworks are key to avoiding the negative ramifications of incurring debt.

Our group of authors, who once again contributed their time and expertise on a *pro bono* basis, include academics, economists, financial advisors, researchers and lawyers from multilateral organisations, leading international law firms and established financial advisory firms with extensive experience in sovereign finance and debt restructuring. These authors have created a resource that provides a well-balanced, multi-disciplined perspective on sovereign financing and debt management in an easily digestible format.

It is our unwavering belief that this handbook will continue enhancing African governments' understanding, utilisation and management of their debt. While encouraging further discussion and scholarship, the handbook is not a substitute for obtaining professional advice.

On behalf of the ALSF, I wish to thank all of the contributing authors and remote collaborators for their enthusiasm, passion and commitment while developing this handbook. While the process was intense, it was fuelled by vast experience, dedication, tenacity and debate. The handbook reflects the views and collective voices of these experts, as well as those of key African stakeholders.

I also wish to thank the African Development Bank (AfDB), The International Monetary Fund (IMF), the West African Institute for Financial and Economic Management (WAIFEM) and the Commonwealth Secretariat (COMSEC) for their support. The handbook was produced using the Book Sprint method, which facilitates developing and drafting a complete book in just five days. I would also like to thank the Book Sprints team (*http://www.booksprints.net/*), particularly Jana Mendelski, Barbara Rühling and Alysa Khouri for their sturdy stewardship and creativity throughout the process.

Finally, I express thanks to the ALSF's strategic and logistic planners, Toyin Ojo, Nicole Kearse and Alain-Stephane Moulot. The handbook is currently available in electronic form. It will be translated into French, Portuguese and Arabic.

**Olivier Pognon**
**Director and CEO**
**The African Legal Support Facility**

## THE AFRICAN LEGAL SUPPORT FACILITY

The African Legal Support Facility (ALSF) is an international organisation which broadly aims to remove asymmetric technical capacities between public- and private-sector stakeholders. The ALSF was originally established in response to the rise in vulture fund litigation against African sovereigns but quickly moved into assisting African governments in the negotiation of complex commercial transactions. The ALSF intervenes in matters related to the sovereign debt, power, infrastructure and extractive sectors.

***www.alsf.org***

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## Disclaimer

This handbook is the collective product of its authors. No single view expressed in this handbook should be attributed to any individual author and none of these views necessarily represent the views of any of the institutions and organisations (or their respective governors, directors, managers and clients) where each author works.

This handbook is an overall guide and does not contain definitive financial or legal advice. Readers considering any of the issues discussed in this handbook should seek to speak at an early stage with their advisors.

# Introduction

This handbook is intended to empower sovereign debt managers and other officials involved in sovereign debt in Africa by demystifying relevant concepts and terminology and serving as a practical guide to public finance. The handbook was originally published in 2019, before the Coronavirus (COVID-19) pandemic that brought the world economy to a sudden stop. The impact of the pandemic caused severe financing pressures on Emerging Markets and Developing Economies (EMDEs), necessitating emergency measures that galvanised a coordinated global response as EMDE governments grappled with rethinking priorities and pivoting to address new challenges. The consequences of the pandemic, and other exogenous shocks and developments in the financial architecture warranted the update of this valuable resource.

The aforementioned and the feedback received from the first version of the book has necessitated a new edition emphasizing areas where there has been greater discussion and addressing new developments. For example, the Sections on "Types of Creditors" and "Types of Financing" highlight the impact and integration of Environmental Social and Governance (ESG) tools on debt instruments and the emergence of sustainability financing. The handbook also discusses the establishment of some official bilateral creditors that became relevant in 2019 and are now, in some instances, Africa's biggest lenders. The "Sovereign Debt Management" Section has been expanded to provide a more granular analysis of the considerations involved. The Section on "Contingent Liabilities" has become a standalone chapter due to its importance and the recurrent problems African governments are facing in this area.

As stated in the 2019 version of the handbook, sovereign debt management has elements of both "science" and "art". The "science" comprises the technical, financial and legal aspects of debt instruments and the markets in which they are traded. The "art", however, is how sovereign debt managers develop and implement strategies related to debt financing, and determine how much to borrow, which resources to use, how to structure them, with whom and how to interact, how to prevent debt distress, and crucially, what to do if a crisis hits. The first sections of this handbook focus on that "science". In this context, the broad reasons for borrowing debt, the various sources of financing and the most commonly used instruments are examined. The second part of the handbook considers both the science of sovereign debt management (the functions, frameworks and tools available to debt managers and issues related to data management) and the art of sovereign debt management (the process for developing a debt strategy).

Some of the fundamental issues on the African continent are the gaps in the institutional governance within bodies tasked with managing sovereign debt. A specific chapter has been dedicated to the support available to governments, and more specifically, the role of private sector advisors. Independent, professional advisors for financial, legal and communications assignments are critical in assisting governments in achieving their objectives, not just in crises. The chapter identifies the technical assistance and capacity building that should complement *but not act as a* substitute for the engagement of independent professional advisors. The chapter examines the function of these advisors and considers how and when they should be procured. The handbook concludes by delving into the art of navigating times of debt distress and how to recover and restore resilience to the country.

The handbook, without the intention of being a "deep dive", is designed to provide a solid basis for the topics to facilitate an understanding of complex subject matter. Moreover, cross-referencing other ALSF resources, mainly the ALSF Debt Guides, encourages the quest for deeper understanding. These ALSF Guides cover the following topics:

1. Development and Sustainability Focused Financing;
2. Debt Swaps;
3. Key Considerations for Incurring Non-Traditional Debt;
4. State-Contingent Debt Instruments;
5. Governance and Transparency;
6. Fiscal Policy; and Management;
7. Pre-Crisis and Crisis Management.

The ALSF Debt Guides are available at: *www.alsf.int*

# 1 Landscape of African Sovereign Debt

With the world's youngest population, abundant natural resources and rapidly growing economies, the African continent is at a crossroads of opportunities and challenges. To achieve their potential, African countries will need significant investment in their human and physical capital, whether it be education, health, infrastructure or, more critically, energy.

This investment requires the raising of financial resources which will see Africa's developmental goals succeed without mortgaging its future. For example, according to the African Development Bank (AfDB), infrastructure investment in Africa alone requires USD 130 billion to USD 170 billion annually, with a financing gap of USD 108 billion (see African Economic Outlook 2018). To raise this amount, African countries need to both mobilise domestic capital and attract an enormous amount of external resources.

Most of these domestic and international resources will be in the form of debt. Debt, in its many varieties — official, private, domestic and external — has helped many African countries achieve their development objectives and contributed to their overall economic growth.

Nonetheless, there are risks associated with the growing amounts of debt, including the high cost of debt servicing at the expense of investment in other development priorities. Such risks must be mitigated by well-designed macroeconomic policies, sound debt management processes and strong institutions, allowing debt to fuel economic development in a virtuous growth cycle.

# Historical Context

The historical context of Africa's debt is of great importance. We must all learn from the past to avoid the same mistakes in the future. Drivers of debt accumulation and challenges in several African countries have included persistent structural weaknesses in the form of poor domestic revenue mobilisation, lack of expenditure controls, weak growth, terms of trade shocks, vulnerability to climate and other exogenous shocks as well as governance challenges.

Debt relief does not address the underlying factors contributing to unsustainable debt accumulation. The experience of many African countries, following the completion of debt relief initiatives, such as the Heavily Indebted Poor Countries (HIPC) Initiative, offers a salient lesson of missed opportunities.

The history of sovereign debt in Africa over the past 50 years can be segmented into distinct periods, each characterised by significant developments in how African countries have managed and responded to their debt burdens.

### 1970s — OIL PRICE SHOCKS, EASY CREDIT AND HEAVY BORROWING

In the 1970s, many African countries, including newly independent ones, borrowed heavily from international lenders, including the World Bank, the International Monetary Fund (IMF), official bilateral creditors, as well as commercial banks. Their objective was to finance development projects and industrialisation efforts. The availability of easy credit during this period, facilitated by the recycling of the huge surpluses of oil exporting countries through the international banking system, allowed many African countries to borrow heavily and to increase public expenditures sharply. These loans were also often encouraged by the lenders themselves and were seen as a means to stimulate economic growth for the Continent's development.

However, oil-importing African countries were adversely affected by the oil price hikes of 1973 and 1979, which increased energy costs. Together with volatile commodity prices, these contributed to persistent balance-of-payments disequilibria. While a few African countries undertook policy measures to address this challenge, most relied on foreign borrowing to fill the resulting financing gaps.

## 1980s — GLOBAL RECESSION AND A SHARP DECLINE IN NON-OIL COMMODITY PRICES

The global recession of the early 1980s, marked by high-interest rates in developed countries, led to a sharp increase in the cost of debt servicing for African countries, many of which had borrowed heavily at variable interest rates. Another major external shock to African economies was the continuing decline in non-oil commodity prices. Many African countries, reliant on the export of a few primary commodities, found their revenues falling just as their debt service costs were rising.

In addition to these external factors, economic mismanagement and inappropriate domestic policies (for example, overly expansionary fiscal and monetary policies) adopted by some African countries aggravated the situation. Economic growth stagnated and many countries could not service their debts, leading to arrears and further borrowing. In addition, a severe drought afflicted many regions of Africa. The convergence of these factors led to widespread debt crises across the Continent, with many countries defaulting or restructuring their debts.

In response to the growing debt crisis, many countries embarked on Structural Adjustment Programmes (SAPs) with the assistance of the IMF and World Bank which aimed to stabilise economies and restore growth through economic reforms. However, these programmes came with social costs and mixed success in restoring debt sustainability. This decade has been called Africa’s “lost decade” of development opportunities.

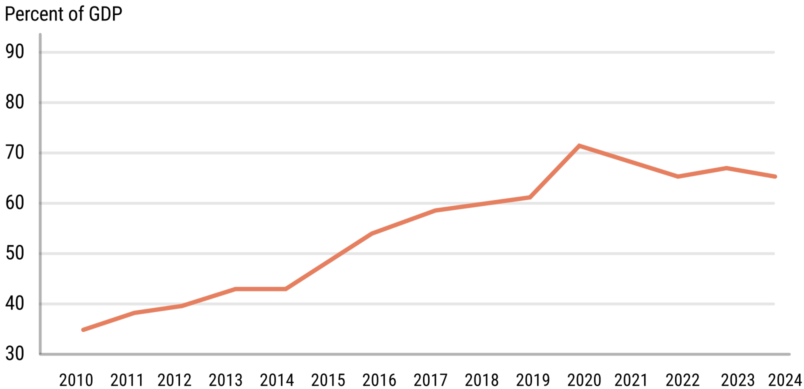
## 1990s AND 2000s — LAUNCH OF DEBT RELIEF INITIATIVES

Recognising the unsustainable debt burden on the world’s poorest countries, the IMF and World Bank launched the HIPC Initiative in 1996 to provide a comprehensive official sector debt relief framework. Thirty-three of the 39 eligible countries are in Africa. To participate in the HIPC Initiative, countries had to meet certain criteria and commit to implementing certain actions to receive debt relief.

To further reduce the debt of eligible countries, the HIPC Initiative was supplemented by the Multilateral Debt Relief Initiative (MDRI) created in 2005 to provide 100% debt relief on eligible debts. As of March 2024, all eligible African countries, other than Sudan and Eritrea, had completed HIPC and received full debt relief.

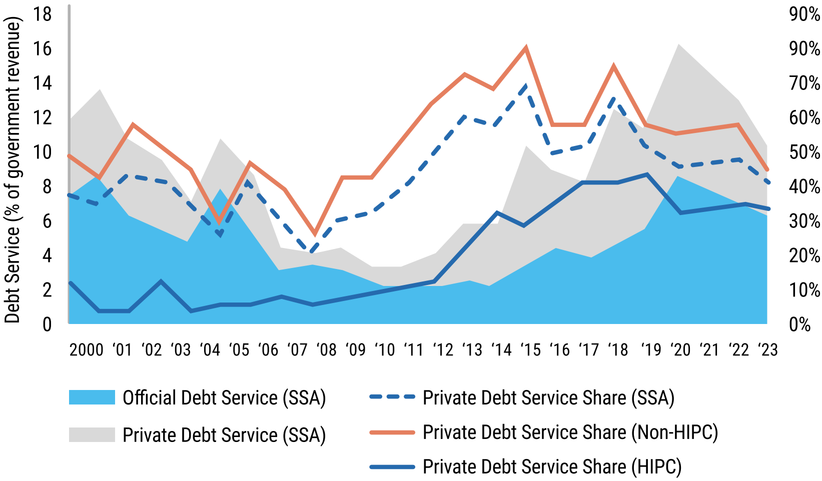
## The Current Context

Sovereign debt in Africa has subsequently grown to levels not seen in decades. The average debt to GDP ratio in sub-Saharan Africa has almost doubled — from 30% at the end of 2013 to almost 60% by the end of 2022 (please see *FIG.1.* and *FIG.2.* below). The cost of servicing this debt has also increased, with the ratio of interest payments to revenue more than doubling since the early 2010s, heightening debt sustainability concerns. As of November 2023, the IMF/World Bank identified 13 African countries at high risk of debt distress with 7 already in debt distress.




Source: AfDB staff calculations based on the IMF World Economic Outlook database

FIG.1. Sovereign Debt (% of GDP), 2010-2024




Note: Values after 2020 are 'scheduled' and will not likely reflect the debt servicing that country groupings will eventually pay.
Source: International Debt Statistics. World Bank Group.

FIG.2. Composition of Sovereign Debt Service, 2000-2023

## A MORE COMPLEX DEBT STOCK AND DIVERSE CREDITOR LANDSCAPE

Recent decades have witnessed (a) a sharp increase in lending to African countries from China, India, Saudi Arabia, the Islamic Development Bank and other institutions in Asia and the Gulf; (b) a shift from concessional borrowing to commercial financing, in particular, in the international capital markets; and (c) multinational trading groups, interested in long-term commodity purchase contracts, offering finance tied to commodity deliveries. There has been a corresponding growth of state-owned enterprises (SOEs) financial liabilities, subnational debt and related contingent liabilities.

## A SERIES OF GLOBAL SHOCKS

In recent years, African countries have had to deal with the consequences of a series of global shocks including the COVID-19 pandemic, the Russian invasion of Ukraine and ever-growing climate-related emergencies. These shocks have resulted in a sharp increase in commodity prices, inflationary pressures and a tightening of global financing conditions. This, in turn, has compounded financial stress and led to a deterioration of governments' fiscal positions, thereby increasing sovereign debt borrowing.

### UNCERTAINTY ABOUT THE SOURCES OF NEW FINANCING

Beyond this, it is increasingly challenging for African countries to obtain new financing. Aid budgets in advanced economies have shrunk. China, a major creditor in Africa, also appears to be reducing net flows to the Continent. Reforms to expand the balance sheet and firepower of Multilateral Development Banks (MDBs), traditionally large lenders to African countries, are facing political and technical headwinds. For many African countries, access to financial markets has become more difficult, exacerbated by a higher interest rate environment than in the previous decade. These challenges threaten the ability of African countries to meet their immediate funding and future finance for growth needs, especially those tied to the United Nations (UN) Sustainable Development Goals (SDGs).

## International Response to Current Challenges

The international community has responded to some of these challenges, including through the initiatives below:

### G20 DEBT SERVICE SUSPENSION INITIATIVE (DSSI)

Faced with the challenges of the COVID-19 pandemic, in May 2020, the G20 — urged by many of its leaders, the World Bank, the IMF and civil society organisations — set up the Debt Service Suspension Initiative (DSSI). The DSSI offered IDA-eligible countries the option to suspend their debt service to official bilateral creditors from May 2020 to December 2021 to deploy their resources to fight the pandemic and safeguard the lives and livelihoods of the most vulnerable people. The 30 African countries participating in this initiative were offered the option to repay any deferred debt-service payments over three years with a one-year grace period after December 2021.

### COMMON FRAMEWORK FOR DEBT TREATMENT BEYOND DSSI

Building on the DSSI, in November 2020, the G20 launched the Common Framework for Debt Treatment Beyond the DSSI (Common Framework) to provide a collective forum for addressing the liquidity and debt sustainability problems faced by IDA-eligible countries. Under this framework, eligible countries could ask for their debt to be restructured under an IMF-supported programme in a single forum. As of March 2024, four countries had applied to the Common Framework, all in Africa: Chad, Ethiopia, Ghana and Zambia. The Global Sovereign Debt Roundtable (GSDR) was established in 2023 as a discussion forum for representatives from the official and private sectors and debtor countries to streamline the sovereign debt restructuring process and build stakeholder consensus.

## FINAL CONSIDERATIONS

The landscape and the current contact are very challenging. The tools are "there" but the tasks seem daunting. This Handbook will hopefully shed some light, demystify the subject area and empower readers to be able to better manage sovereign debt and face the current challenges with significant know-how.

# Types of Creditors

# *Key Points*

*A sovereign borrower has different financing options and for each such option a choice of creditors.*

*Creditors to sovereigns include multilateral creditors (e.g., the IMF, World Bank, AfDB), official bilateral creditors and private creditors (e.g., commercial creditors and bondholders).*

*To manage their debt prudently and soundly, sovereigns need to understand the types of creditors, their interests, the proposed debt instruments and the creditors' funding and capital structures.*

*The range of creditors active on the Continent evolves with lending now available also from non-traditional sources, e.g., plurilateral creditors or commodity traders.*

# 2 Multilateral Creditors

Multilateral creditors are official organisations with global or regional memberships that leverage funds contributed by their members to promote economic growth and stability through loan financing. Multilateral creditors are governed by their relevant legal and policy frameworks and may provide financing on both concessional and non-concessional terms. This chapter provides a brief overview of the most prominent (and most active) multilateral creditors in the African market.

## The International Monetary Fund

Established in 1944, the IMF promotes the stability of the international monetary and financial system. In discharging its mandate, the 190-member IMF monitors the economies of its member states (surveillance), provides financial assistance to countries with balance-of-payments problems and supports sound macroeconomic policy through technical assistance. The IMF also promotes international financial stability and monetary cooperation. It facilitates international trade, promotes employment and sustainable economic growth, and helps to reduce global poverty.

To carry out this mandate, the IMF may provide financial assistance to member countries in line with two requirements established by its Articles of Agreement:

1. Financial assistance is provided to help a member resolve its balance-of-payments problem and cannot be used for any other purpose. In addition, the IMF provides financial support to member countries hit by crises to create breathing room as they implement policies that restore economic stability and growth. Finally, the IMF also provides precautionary financing to help prevent crises.
2. The borrowing member country must repay the IMF for the financial assistance received (Please refer to *TABLE 1. IMF Financing Facilities and Instruments*).

For the IMF to provide financing, including as a "lender of last resort", members must implement a programme of economic, financial and structural reform designed to address the underlying balance-of-payments or structural problem. In practice, following a request from a member country, an IMF staff team holds discussions with the authorities to assess the economic and financial causes of the balance-of-payments or structural problems and the amount of financing needed to address the problem. The member government and the IMF then agree on a programme of economic and structural policy adjustments. This reform programme is presented to the IMF's Executive Board to approve an arrangement supporting the programme. Following approval by the Executive Board, the member may then access financing from the IMF if it meets the conditions of the reform programme, which is referred to as "conditionality". The Executive Board monitors the implementation of the reform programme through reviews. The IMF provides financing (including emergency assistance) from several sources.

### GENERAL RESOURCES ACCOUNT (GRA)

The IMF's principal account consists of a pool of currencies and reserve assets, representing the paid subscriptions of member countries' quotas. The GRA is the account from which the IMF's regular lending operations are financed.

### POVERTY REDUCTION AND GROWTH TRUST (PRGT)

The PRGT is the IMF's main vehicle for providing concessional financing (currently at zero interest rates) to eligible low-income countries (LICs).

### RESILIENCE AND SUSTAINABILITY TRUST (RST)

Operational since October 2022, the IMF's Resilience and Sustainability Trust (RST) provides longer-term, affordable financing to help low-income and vulnerable middle-income countries build resilience to external shocks that pose macroeconomic risks such as climate change and pandemic preparedness. The RST supports policy reforms that reduce macro-critical risks associated with climate change and pandemic preparedness.

Key terms and conditions of the IMF lending instruments are summarised in *TABLE 1. IMF Financing Facilities and Instruments* in the Chapter "*Multilateral Financing*".

# The World Bank Group

The World Bank Group, also established in 1944, is an international development organisation with 189 member countries comprising five institutions working in partnership for sustainable solutions. Its goal is to reduce poverty by lending money to the governments of its poorer members to finance development projects. The World Bank Group's primary lenders to sovereigns are the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA).

### THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT (IBRD)

Established in 1944, the IBRD offers innovative financial solutions to middle-income countries and creditworthy poorer countries, including financial products (loans, guarantees and risk management products) and knowledge and advisory services (including on a reimbursable basis) to governments at the national and subnational levels. It finances investments across all sectors and provides technical support and expertise at each stage of a project. IBRD's resources supply borrowing countries with needed financing and serve as a vehicle for global knowledge transfer and technical assistance.

### THE INTERNATIONAL DEVELOPMENT ASSOCIATION (IDA)

The IDA, established in September 1960, is responsible for helping the world's poorest countries. Overseen by 173 shareholder nations, the IDA aims to reduce poverty by providing zero- to low-interest loans (called "credits") and grants for economic development programmes.

### THE MULTILATERAL INVESTMENT GUARANTEE AGENCY (MIGA)

MIGA was created in April 1988 to promote cross-border investment in developing countries by providing guarantees (political risk insurance and credit enhancement) to investors and lenders.

### THE INTERNATIONAL FINANCE CORPORATION (IFC)

Created in July 1956, the IFC is the private sector arm of the World Bank Group, which shares its mission to reduce global poverty. It offers solutions through firm-level interventions, such as investment services product lines like loans, equity investments, trade and commodity finance, derivatives, structured finance and blended finance.

### THE INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES (ICSID)

ICSID, established in October 1966, is an arbitration institution for international investment legal dispute resolution and conciliation between international investors and countries.

For more information on the terms available from these institutions, refer to *TABLE 2. IDA Lending Facilities and Instruments* in the Chapter "*Multilateral and Bilateral Financing*".

## The African Development Bank Group

The African Development Bank Group (AfDB Group) comprises three entities: the AfDB, the African Development Fund (ADF) and the Nigerian Trust Fund (NTF).

### THE AFRICAN DEVELOPMENT BANK

The AfDB, founded in 1963, is an MDB that aims to reduce poverty and improve economic conditions in Africa. Originally, only African countries were permitted to join the bank, but since 1982, membership has been open to non-African countries as well. The AfDB pursues its mission by providing financing to African governments and private companies investing in the bank's Regional Member Countries (RMCs) for projects and programmes expected to contribute to economic and social development in Africa.

### THE AFRICAN DEVELOPMENT FUND

The ADF was established in 1972 and commenced operations in 1974. The ADF promotes economic and social development in the 38 least-developed African countries. Unlike the AfDB, the ADF provides funding on a concessional basis for projects and programmes.

### THE NIGERIAN TRUST FUND

The NTF, a self-sustaining, revolving fund created in 1976 by an agreement between the AfDB Group and the Nigerian government, provides concessional financing to the AfDB's low-income RMCs in order to assist those countries in their development efforts.

## A Note on Preferred Creditor Status

Multilateral institutions generally enjoy preferred creditor status (PCS) over all other creditors. PCS, a *de facto* preference and not a legal one, originated in the context of debt restructuring by the Paris Club. Generally, both official bilateral and private creditors agree to exclude multilateral creditors from the restructuring process. This treatment reflects their recognition of multilateral financing as a public good.

# 3 Official Bilateral Creditors

A sovereign (or a sovereign entity) lending to another sovereign is considered a bilateral official creditor. The approval of such loans usually fits within the broader government-to-government relationship, which includes trade, official development assistance, foreign direct investments and broader political cooperation. Therefore, debt managers need to keep in mind these various aspects when considering the terms of official bilateral loans.

The granting of bilateral official loans involves a wide variety of government institutions on the creditor's side, including presidencies, ministries of finance, ministries of foreign affairs, development, cooperation and/or commerce, Central Banks, national development banks, export credit agencies and export-import banks, policy banks and sovereign wealth funds.

These government agencies have different objectives, approaches and incentives which translate into different loan conditions which are discussed further in the Section "Types of Financing". Understanding the decision-making process in such financings is essential given the intricacies of governmental approval of each official bilateral creditor.

Finally, it is important to note that the line between official and commercial creditors has become increasingly blurred in recent years, especially regarding policy banks that can be state-owned but act commercially. Sometimes, the distinction can even appear between different lending functions of a given entity that might extend some of its loans on behalf of a government — e.g., with direct budget subsidies for concessional loans — but have the rest of its operations conducted commercially.

# 4 Private Creditors

Private sector creditors offer an important source of financing to sovereign borrowers. However, unlike multilateral or official bilateral creditors, private sector creditors provide funds to the sovereign borrower on commercial terms determined by market forces. Private sector creditors can broadly be grouped under commercial lenders and bondholders (domestic and external).

## Commercial Lenders

Commercial debt is not concessional or policy-based financing. It is provided through an array of instruments for the purposes and on the terms agreed upon by negotiation between the sovereign debtor and commercial lender.

Both domestic and foreign lenders provide commercial debt to sovereigns. Domestic commercial obligations are typically governed by the domestic law of the relevant sovereign, while foreign commercial obligations are typically governed by English, New York or other foreign law. The choice of domestic or foreign law can have important legal consequences.

Domestic commercial debt may be provided in the form of credits extended by banks, pension funds, asset managers, institutional investors or (in some cases) wealthy individuals or families resident in the country. The extended credit can be denominated in domestic or foreign currency, depending on the relevant sovereign's exchange control regime and other circumstances.

The spectrum of foreign commercial creditors who participate in debt financings for sovereign borrowers has expanded to include a variety of lenders. Lending may be provided in the form of a credit extended by a single foreign bank to the sovereign (a "direct loan") or by a syndicate of banks (a "syndicated loan"). This is considered to be regulated lending because it is granted by regulated entities, i.e., commercial banks. One aspect of regulated lending is the capital requirements regime put in place to mitigate the risk of failure of commercial banks. This regime may make certain types of loans more expensive and onerous for the regulated lender.

The costs and other burdens of capital requirements have led to decreased lending by regulated entities. Unregulated institutional investors, such as pension funds, asset managers and private credit funds, have moved to cover the demand for finance. These investors lend directly to sovereigns, bypassing the regulated financial institutions that have historically intermediated such facilities. Their ability to offer commercial debt products more flexibly has given them an advantage over regulated entities.

One of the new types of lenders is regional development finance institutions, which also provide commercial lending; please see the box "Regional Financial Institutions" below.

The widening of the market is beneficial overall, and a number of these new investors are valuable partners in the country where the borrowing is made. At the same time, some new investors may offer short-to-medium term financing with more onerous terms and conditions (e.g., collateral, quasi-collateral, guarantees, multiple fees, higher interest rates and very sensitive default triggers). The need for countries to scrutinise all offers, especially the unsolicited ones, is even more important. Appropriate external advisors can assist in identifying and explaining provisions which are onerous and can also assist in the negotiation with these new investors.

## Regional financial institutions

Recent years have also witnessed an increase in lending from regional financial institutions, sometimes referred to as "plurilaterals", e.g., Africa Finance Corporation (AFC), African Export-Import Bank (Afrexim), ECOWAS Bank for Investment and Development (EBID), West Africa Development Bank (BOAD), The Eastern and Southern African Trade and Development Bank (TDB). These institutions differ from multilaterals primarily in two respects: scope of membership and lending policies. In contrast to multilateral creditors, regional financial institution creditors' membership is typically regional rather than global and often includes non-official sector members, such as Central Banks, government agencies and private shareholders. Most significantly, regional financial institutions typically lend on terms which are either not as concessional as multilateral lenders or which approximate those available in the commercial market. The kinds of projects regional financial institutions can lend to are also broader than those multilateral lenders can typically support.

## Islamic Banks

Islamic banks, sometimes called Islamic finance or Shari'ah-compliant banks, adhere to Shari'ah (Islamic law) principles, as described in more detail in the Chapter "*Shari'ah Compliant Sovereign Debt*". They feature heavily in African sovereign financing. Examples of these banks include the Islamic Development Bank, Taj Bank and Jaiz Bank. These multi-purpose institutions perform the roles of commercial, investment and development banks.

# 5 Bondholders

The international and domestic capital markets in Africa are an important source of financing for all sovereigns. Debt securities issued in the local market are usually denominated in local currency and governed by local law. International capital market debt is issued in the form of Eurobonds. It is denominated in a hard currency (i.e., CHF, EUR, GBP, JPY or USD) and is usually governed by English or New York law. These bonds can be privately placed or publicly offered to many investors. Investors have very different investment mandates and diverging fiduciary duties to obtain a return commensurate to their risk.

## International Investors

The most common type of international investors are long-term investors, often referred to as "real money" investors. They include mutual funds, pension funds, insurers, foreign Central Banks or sovereign wealth funds. Many of these investors follow the main fixed-income indices and do not trade bonds actively on a daily basis. They usually constitute most of the allocation when a country issues a bond. With some exceptions, so far, real money investors have built little exposure to local currency markets in Africa, apart from the markets of the Continent's biggest economies.

Hedge funds/specialised distressed investors look for opportunities to buy sovereign debt securities at discounted prices, in anticipation of making a return on their investment when the price of the debt security subsequently improves. These secondary-market investors play an important role in providing liquidity to market participants in the secondary market. Their behaviour in the context of distressed sovereign restructuring transactions can range from very cooperative to highly uncooperative. Sovereign borrowers must understand the motivations and objectives of secondary-market investors, which may differ substantially from those of primary market participants.

Some specialised hedge funds can focus on local currency investments in frontier markets, where they can build significant positions.

As sovereigns consider issuing bonds to fund sustainable or green projects, they may seek to attract impact investors. Impact investors differ from other investment funds in that they are driven not only by profit but also by a desire to enact positive change in society and the environment. They seek opportunities to fund ventures that address pressing global challenges such as poverty, inequality or climate change. By deploying capital strategically, impact investors aim to catalyse sustainable solutions and contribute to building a more equitable and environmentally conscious world.

Beyond impact investors, who remain limited in scale, mainstream long-term investors are gradually incorporating environmental, social and governance (ESG) considerations into their investment strategies. Debt managers should monitor this trend to ensure that their issuance strategy fits with the evolving demands of their investor base.

## Domestic Capital Market Participants

Domestic banks are often the main holders of domestic debt instruments. Their behaviour is partly driven by the regulatory environment, notably the risk weighting of government bonds or mandatory reserve requirements. Domestic banks can also build significant positions in the government's foreign-currency debt instruments. When holdings of government debt by domestic banks become too significant, this can crowd out credit to the private sector and hamper growth — in extreme cases this can even threaten financial stability through a sovereign-bank doom loop.

Domestic mutual funds are similar to the long-term investors described above, and their appetite for government debt will notably depend on the depth of the market and the availability of other investment opportunities. Domestic institutional investors including pension funds and insurance companies generally behave similarly unless they are controlled by the state and thus constrained in their investment strategies and forced/incentivised to hold government debt.

## Diaspora Bondholders

Diaspora bondholders are citizens of sovereigns residing abroad who invest in bonds issued by their home countries, specifically targeting the country's diaspora, to fund development initiatives.

# Types of Financing

## *Key Points*

*A sovereign has access to different financing options. These include sovereign loans (concessional and non-concessional), bonds, and Shari'ah-compliant debt.*

*It is important to understand the main features of these instruments and the associated relevant documentation, debt contracting processes and frameworks.*

*Some specific or more technical aspects should be looked at carefully by the sovereign borrower to better understand the potential implications, e.g., creditor engagement, ranking of creditors, negative pledge, cross-default, etc.*

*Understanding the contractual provisions and how the indebtedness is incurred, are instrumental to comprehending the sovereign's potential commercial and litigation risks.*

# 6 Multilateral Financing

Multilateral creditors and official bilateral creditors offer a range of instruments, usually linked to an economic programme or policy reforms. Below are the salient details of these instruments, listed by the type of creditor providing the financing.

Multilateral financing is often given within the context of development or other policy objectives. The advantage of such financing is that the financial terms are "concessional", meaning below the market rate that the borrower would receive from commercial lenders (i.e., with a grant element). Due to the need for strict oversight and compliance with environmental and social protections, multilateral financing requires that the sovereign submits to significant diligence.

MDBs with both concessional and non-concessional windows have graduation policies which determine the terms of the loans they may provide to a sovereign. The main criterion triggering the graduation process is gross national income (GNI) per capita, with the same thresholds applied by the World Bank and the AfDB. Graduation to non-concessional assistance takes place only when the country is assessed as being able to access international financial markets, a creditworthiness assessment that applies to the World Bank and the AfDB, although based on different criteria.

Financing from MDBs often takes the form of (a) direct loans to sovereign and other public sector entities and (b) guarantees to commercial lenders, either international or within the sovereign's market, that then, in turn, lend to the sovereign or a subnational entity.

Additionally, MDB loans can be divided into budget support and project loans. This can have an impact on the conditions attached to the loans as well as on their accounting, including in the context of international financial statistics (e.g., the contribution to a financing gap in the context of an IMF-supported programme).

The IMF has a different mandate than MDBs; specifically, it intends to promote international monetary and financial stability. It provides financial assistance to help its member countries address balance-of-payment problems. Its financing usually has a shorter maturity than that of MDBs and conditionalities will focus on different objectives than development. The IMF also administers the PRGT to provide concessional financing to LICs and the RST which was created in 2022 to support countries in addressing the long-term structural risks related to climate change and pandemic preparedness.

## The International Monetary Fund

The IMF's various financing instruments are tailored to address different types of balance-of-payments problems. LICs may borrow on concessional terms through facilities available under the PRGT. The Extended Credit Facility is the main tool for providing medium-term support to low-income countries facing protracted balance-of-payments problems. Historically, the Standby Arrangements have been the primary source of assistance to member countries, seeking to address short-term balance-of-payments problems for emerging and advanced countries in crisis. The IMF also provides prompt financial assistance to any member facing an urgent balance of payments needed under the Rapid Financing Instrument and the Rapid Credit Facility. The provision of financing under these facilities and instruments is governed by the IMF's legal framework and relevant policies including access, conditionality, debt sustainability and financing assurances.

TABLE 1. IMF Financing Facilities and Instruments (Source: IMF 2023: Extended Credit Facility Factsheet)

| Facility | Purpose | Duration | Financing | Repayment |
|---|---|---|---|---|
| Standby Arrangement (GRA) | Present, prospective, or potential shorter-term balance of payments need. | Up to 3 years, but usually 12-18 months. | Commitment fee, service charge and lending rate (SDR interest rate plus a margin); surcharge for large loans. | 3¼-5 years. |
| Extended Fund Facility (GRA) | Balance of payments need arising from serious payments imbalances due to structural impediments, or characterised by slow growth and an inherently weak balance of payments position. | Up to 4 years. | Commitment fee, service charge and lending rate (SDR interest rate plus a margin); surcharge for large loans. | 4½-10 years. |
| Flexible Credit Line (GRA) | Present, prospective, or potential balance of payments need (for countries with very strong economic fundamentals and policies). | 1 or 2 years. | Commitment fee, service charge and lending rate (SDR interest rate plus a margin) and surcharges. | 3¼-5 years. |
| Precautionary and Liquidity Line (GRA) | Present, prospective, or potential balance of payments need (for countries with sound economic fundamentals and policies). | 6 months (liquidity window), or 1 or 2 years. | Commitment fee, service charge and lending rate (SDR interest rate plus a margin) and surcharges. | 3¼-5 years. |
| Rapid Financing Instrument (GRA) | Actual and urgent balance of payments need. | Outright purchase. | | 3¼-5 years. |
| Short-term Liquidity Line (GRA) | Potential, moderate, short-term balance of payment needs related to capital account pressures arising from external developments. | 12 months. | Commitment fee, service charge, lending rate (SDR interest rate plus a margin) and surcharges. | 12 months. |
| Extended Credit Facility (PRGT-eligible countries) | Protracted balance of payments need. | 3 to 4 years, extendable to 5 years. | Zero interest. | 10 years, with a grace period of 5 ½ years. |
| Standby Credit Facility (PRGT-eligible countries) | Present, prospective, or potential balance of payments need. | 1 to 2 years. | Zero interest; availability fee. | 8 years, with a grace period of 4 years. |
| Rapid Credit Facility (PRGT-eligible countries) | Actual and urgent balance of payments need. | Outright disbursement. | Zero interest. | 10 years, with a grace period of 5 ½ years. |
| Resilience and Sustainability Facility | Prospective balance-of-payments stability. | Coincide with the remaining duration of the accompanying IMF upper credit tranche programme (financing or non-financing). | A tiered interest structure with LICs benefiting from more concessional terms. | 20 years, with a grace period of 10 ½ years. |

# The World Bank Group

## THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT (IBRD)

The IBRD offers loans to middle-income countries at lower interest rates and repayment periods that are longer than those offered by commercial banks. The lower cost of lending by the IBRD allows borrowers to pursue projects or programmes with an economic development benefit.

## THE INTERNATIONAL DEVELOPMENT ASSOCIATION (IDA)

The IDA provides loans and grants for economic development programmes designed on concessional terms. 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 repayment grace period. IDA may also provide grants to countries at higher risk of debt distress.

TABLE 2. IDA Lending Facilities and Instruments (Source: The World Bank 2023: IDA Terms Effective as of January 1, 2024)

| Form of IDA financial support | Maturity | Grace period | Principal repayments | Acceleration clause |
|---|---|---|---|---|
| Grants | No repayment. | N/A | N/A | N/A |
| Small Economy loans | 40 | 10 | 2% for years 11-20, 4% for years 21-40. | Yes |
| Regular loans | 38 | 6 | 3.125% for years 7-38. | Yes |
| Blend loans | 30 | 5 | 3.3% for years 6-25, and 6.8% for years 26-30. | Yes |
| Guarantees | N/A | N/A | N/A | N/A |
| Non-Concessional Financing (IDA 18 scale-up facility and transitional support) | Up to 35 years maximum maturity, up to 20 years average maturity. | | Flexible. | N/A |

# The African Development Bank Group

## THE AFRICAN DEVELOPMENT BANK

The AfDB provides loans to African borrowers on more favourable terms than commercial lenders. These loans are categorised as either sovereign-guaranteed loans (SGLs) or non-sovereign-guaranteed loans (NSGLs). SGLs are loans made either (a) at the sovereign level or (b) to public sector enterprises, all of which are supported by a counter-guarantee from the sovereign to the AfDB. NSGLs are loans made either (a) to public sector enterprises, without the requirement of a sovereign guarantee by the host government or (b) to private sector enterprises, in each case provided that the borrowers meet specific eligibility criteria.

TABLE 3. AfDB Lending Facilities and Instruments (Source: African Development Bank: Financial Products Handbook 2022-2023)

| Lending type/facility | Purpose | Duration | Financing terms |
|---|---|---|---|
| Sovereign Guaranteed Loan (SGL) | Loans made to an RMC or public sector enterprise supported by a counter-guarantee from the RMC. | Up to 20 years, with a grace period of up to 5 years. | Commitment fee for policy-based loans; no front-end fees; interest rate terms = base rate + funding margin + lending margin. |
| Non-Sovereign Guaranteed Loan (NSGL) | Loans made to public and private enterprises that meet specific eligibility criteria, without any form of guarantee from the RMC. | Up to 15 years, with a grace period of up to 5 years. | A commitment fee of 0-1%; front-end fee of 1% of the loan amount; appraisal fee on a case-by-case basis; interest rate terms = base rate + lending margin. |
| Synthetic Local Currency Loan (SLCL) | Loans to countries to finance in their own currency to reduce foreign exchange risk, and promote development of the domestic capital market. | Maturity depends on the availability of adequate hedging options for specific local currency loans — up to 20 years for sovereign-guaranteed borrowers, and up to 15 years for non-sovereign-guaranteed borrowers. A grace period of up to 5 years. | Front-end fee of up to 1% flat of the loan amount; commitment fee of up to 1% of undisbursed amount; interest rate terms = base rate + funding margin + lending margin; prepayment premium. |
| Syndicated Loans (A and B loan structures) | To mobilise capital for productive use in viable projects in Africa. | Maturity depends on the structure of the underlying project and participants' risk appetite. AfDB may accept participations having a different maturity profile from the A-loan grace period, as the final maturity on the participation in the B-loan may be shorter than the grace period and final maturity on the A-loan. | A commitment fee of 0-1% for middle-income countries, 0.5%-1% for others; front-end fee of 1% of the loan amount; AfDB may charge appraisal fee on a case-by-case basis; arrangement (praecipium) and syndication fee; loan administration fee; underwriting fee; other fees (e.g., legal and other expenses related to the processing of an A- and B-loan syndication). |
| Partial Credit Guarantees (PCGs) & Partial Risk Guarantees (PRGs) | PCGs can be used to support the mobilisation of private funds for project finance, financial intermediation, and policy-based finance. PCGs cover private lenders against the risk of the government, or a government-owned agency, failing to perform its obligations vis-à-vis a private project. | Maturity of up to 20 years for sovereign-guaranteed borrowers; up to 15 years for non-sovereign guaranteed borrowers. The principal repayment period of financing should match the requirements of the project being financed. For structures with bullet repayments, the maximum period is limited to 15 years and an average life of 10 years. Maturity restrictions may apply to certain guarantee structures and currencies. | For an SGL, no charges; for NSGL borrowers, 1% of the Bank's possible maximum exposure under guarantee; standby fee charged on undisbursed portion of the underlying loan; between 0 and 1% for NSG borrowers from middle-income countries; between 0.5 and 1% for NSG borrowers from other countries; guarantee fee equal to the lending spread that would have been charged if AfDB had made a direct loan, plus a risk premium. Other fees (e.g., legal and other expenses related to initiation, appraisal, and underwriting process of a guarantee; appraisal fees for private sector project); prepayment premium. |

## THE AFRICAN DEVELOPMENT FUND

Unlike the AfDB, the ADF provides funding on a concessional basis for projects and programmes for the promotion of economic and social development. The following is a summary of terms related to ADF loans and lines of credit.

TABLE 4. African Development Fund

| | Maturity | Grace Period | Service Charge | Commitment Fee | Principal Repayment |
|---|---|---|---|---|---|
| ADF Loans | Up to 50 years. | Up to 10 years. | 0.75% p.a. on disbursed and outstanding amounts. | 0.50% p.a. on undisbursed amounts accruing 120 days after loan signature. | 1% of the principal p.a. from the 11th to the 20th year. 3% of the principal p.a. from the 21st to the 50th year. |
| ADF Line of Credit | Up to 20 years. | Up to 5 years. | 0.75% p.a. on disbursed and outstanding amounts. | 0.50% p.a. on undisbursed amounts accruing 120 days after loan signature. | N/A |

## THE NIGERIAN TRUST FUND

The NTF provides concessional financing to the AfDB's low-income RMCs in order to assist those countries in their development efforts. The NTF's resources can be utilised to provide co-financing with the AfDB and the ADF. The NTF can also directly fund public and private sector activities. Of note, unlike AfDB resources, NTF resources are allocated to projects, not sovereigns. Proposals related to the poorest ADF countries, countries with small ADF allocations and fragile states, are particularly encouraged.

TABLE 5. Nigerian Trust Fund

| | Maturity | Grace Period | Service Charge | Commitment Fee | Principal repayment |
|---|---|---|---|---|---|
| Long-term concessional loan | 27 years. | 7 years. | 0.75% p.a. on outstanding balance. | 0.5% p.a. on undisbursed commitments. | 0% of the principal from years 8-27. |
| Short-term concessional loan | 20 years. | 5 years. | 0.75% p.a. on outstanding balances. | 0.5% p.a. on undisbursed commitments. | 0% of the principal from years 6-20. |

# 7 Official Bilateral Financing

Official bilateral financing involves lending from a sovereign (or a sovereign entity) to another sovereign. Depending on the cost of financing, this debt can be either (a) concessional debt, also known as Official Development Assistance (ODA) or (b) non-concessional debt, simply known as "non-ODA" debt. Increasingly, official bilateral creditors are interested in demonstrating that their financing is contributing to the debtor country's meeting the SDGs and particular development outcomes, such as resilience to climate change.

Most developed countries have specialised export credit agencies (ECAs). Some prominent examples of ECAs are the China Export-Import Bank (China EXIM), Coface and Bpifrance (France), Hermes (Germany), UK Export Finance (United Kingdom), SACE (Italy) and US Export-Import Bank (US EXIM). Foreign enterprises seeking to do business in the sovereign's territory or with the sovereign's nationals may get support from one or more of the ECAs (or other export risk insurance) agencies of their own country. Loans that are made with the ECA cover generally have lower interest rates and longer maturities than can be provided by private lenders. Non-ODA debt often arises through loans between a government agency or SOE on the debtor side and, on the creditor side, a commercial partner that benefits from a full or partial guarantee from their specific ECA. Once the guarantee is called, the guaranteed portion of the debt (typically 80%) becomes a claim of the ECA and therefore government-to-government debt.

The legal, operational and financial terms offered by official bilateral creditors can vary widely. For instance, interest rates could range from deeply concessional to commercial. Similarly, the use of security, escrow accounts or collateral will differ based on the preferences of the official bilateral lender.

# 8 Commercial Loans

Commercial loans can be classified in numerous ways depending on the purpose for which, and the person to whom, they are provided. In the context of sovereign debt, the most relevant distinction is between direct loans and multiparty loans.

## Direct Loans

A direct loan involves a single lender, such as a commercial bank, and typically a single borrower, such as the sovereign. This type of loan can be tailored for a specific purpose, e.g., a short-term bridge loan between bond issuances or long-term financing of an infrastructure project. These are almost always floating rate obligations, which result in fluctuations in payments due. Such fluctuations can be mitigated through a hedging strategy (for additional information on hedging strategies, please see the Chapter "*Swaps*").

## Multi-Party Loans

Multi-party loans are loans between a borrower and two or more lending entities. All such loans are "syndicated loans" or "club loans".

### SYNDICATED LOANS

"Syndicated loans" are a form of financing offered by a group of lenders to a borrower (or borrowers). Like direct loans, syndicated loans can also be tailored for a specific purpose. In this structure, a borrower will initially work with one or more commercial banks (the "arranger(s)") who will assist in putting together the syndicate of lending banks. The arranger(s) will negotiate the amount, terms and conditions (including governing law) and the use of funds (project-related financing or financing of a budget deficit, etc.) with the borrower. Terms and conditions will reflect the arranger's assessment both of the quality of the borrower's credit risk and the prevailing market conditions.

Members of the syndicate will later appoint an agent who will carry out all of the syndicate's administrative functions. Payments to and from the borrower will also be administered by and, almost always, flow through the agent.

Syndicated loans are somewhat more complex than direct loans in order to address intra-syndicate issues.

### CLUB LOANS

A "club loan" (also known as a "consortium loan") is similar to a syndicated loan in form and substance. However, syndicated loans are likely to have a larger number of lenders than club loans, with many of the participating lenders primarily interested in the yield of the loan and often lacking an established relationship with the sovereign. Lenders under club loans often have or develop a close relationship with the sovereign. Club loans typically are organised without a formal arranger and one of the participating lenders will assume the administrative functions of the facility.

### SUB-PARTICIPATIONS

Lenders under bilateral commercial loans or syndicated loans have the right to transfer their participation to other lenders. The transfer to another lender can be done either (a) by bringing in that other lender as a participant in the loan with a direct contractual relationship with the borrower or (b) in a manner where that other lender shares in the funding and/or risk of all or part of the loan of the transferring lender without a direct contractual relationship with the borrower. The latter method is known as "sub-participation" and the lender to whom the transferring lender transfers the funding and/or risks is a "sub-participant".

## Commercial Loan Facilities

Direct and syndicated loans are typically granted through facility agreements.

Facilities can take many forms:

1. Revolving facilities that allow a borrower to draw, repay and then redraw again.
2. Term facilities allow the borrower to borrow specific sums for a specified period of time (the "term").
3. Standby facilities that keep the funds in reserve and allow the borrower to withdraw upon satisfaction of pre-determined conditions.
4. Letters of credit/guarantee facilities where the sovereign is obligated to repay the facility lender if the letter of credit/guarantee is called by a third party.

Loan facilities can also allow drawings in multiple currencies, although it is likely that most debt managers will prefer to use the spot and swap markets for managing their currency commitments. Lending facilities can be either secured or unsecured. Given the nature of the sovereign borrower, most sovereign loans are unsecured. The purpose of secured lending is to give the lender access to the pledged security in case the borrower fails to meet its obligations under the loan (e.g., in the case of a default). For more information, refer to the Chapter "*Secured Lending*".

## Loan Documentation

The loan document, called either the "loan agreement", "credit agreement" or "facility agreement", sets out the contractual terms and conditions under which a lender agrees to lend money to a borrower.

Although there is no standard form of contract used for all syndicated loans, there are market guidelines and practices which are widely used. In Europe, the Loan Market Association (LMA), for example, publishes standard form loan agreements and guidance notes on syndicated loan terms.

## Principal Terms and Conditions of a Loan Agreement

The key provisions of loan agreements include:

**Parties:** The names of the parties.

**Facility amounts:** The amounts the lenders are committing to lend.

**Availability period:** The period during which the borrower can ask the lenders to advance the loan.

**Conditions precedent:** The conditions which must be satisfied prior to the loan being advanced to the borrower.

**Purpose of loan:** The purpose for which the borrowed funds will be used.

**Drawing mechanics:** The mechanics under which loans must be requested and advanced (times of request and payment, minimum amounts requested, etc).

**Repayment terms:** The date(s) on which the loan is to be repaid ("maturity date") and, if in instalments, the amounts of such amortisation (repayment) instalments.

**Early voluntary prepayment:** The conditions and mechanics under which the borrower can repay all or part of the loan ahead of its maturity date. Early prepayments may carry the payment of "break" funding costs or fees to the lenders.

**Early mandatory prepayment:** The events that entitle the lenders to require the borrower to prepay all or part of the loan ahead of its maturity date. These events are no-fault early termination provisions and both they and their interplay with the borrower's remaining contractual terms in other debt instruments must be well understood.

**Interest:** Calculation of interest (almost always based on floating interest base rate reflecting the lenders' cost of funds, commonly by reference to an accepted base rate such as SONIA or SOFR), plus a margin, interest periods (typically one, three and six months) and default interest. Interest is calculated either on a 360-day year basis (usually for Euro or US dollar financing) or a 365-day year basis (for Sterling financing).

**Increased costs provision:** This provision is typically included in a loan agreement as a type of "risk allocation provision" to protect the lender in the case of an increase in the cost of lending caused, for example, by a regulatory change.

**Amendments and waivers:** This provision allows a qualified majority of lenders in a syndicated facility or club loan to agree to certain changes to non-financial terms in the loan and to waive breaches of covenant and events of default in the loan agreement. Note that in almost all loan agreements it is not possible to secure amendments to financial and other key commercial terms without the consent of each affected lender.

**Representations and warranties given by borrower:** These are the statements made by the borrower concerning its legal status, authorisation, financial condition, other debt levels, disputes, as well as other factual matters which are of credit interest to the lenders. Incorrect representations or breaches of warranties constitute an event of default under the loan contract.

**Pari passu:** The *pari passu* clause is a representation and an undertaking that holders of the loan rank and will at all times rank equally (*pari passu,* a Latin phrase meaning "on equal footing") with holders of other unsecured and unsubordinated debt obligations of the issuer.

**Undertakings/Covenants:** Loan agreements include three types of undertakings/covenants — affirmative, negative and financial:

1. An affirmative undertaking/covenant is a promise **to do** something under the loan agreement. An example is the promise to obtain and maintain all authorisations required for the validity of the loan agreement.
2. A negative undertaking/covenant is a promise **not to do** something. An example is the "negative pledge", a promise not to create or allow security (or equivalent) over the borrower's assets in favour of third-party creditors. Other negative covenants (which, however, are unlikely to be relevant in the context of sovereign loans) are restrictions on the payment of dividends/distributions, the disposal of assets, the incurrence of financial indebtedness, the granting of security over assets, etc.
3. Financial covenants are not common in sovereign loans. When present in loan agreements, financial covenants seek to ensure that the borrower is maintaining or attaining certain financial targets.

**Sovereign immunity:** Waivers of sovereign immunity include waiver of the immunity from suit (litigation or arbitration) and waiver of immunity from enforcement of attachment/foreign awards over the sovereign's commercial assets.

**Governing law:** This is the law governing the interpretation of the loan agreement. International lenders will usually ask for English or New York law.

**Jurisdiction:** This specifies the type and place of the forum where disputes will be adjudicated. The dispute forum usually follows the governing law, so it will be English or New York courts, or very commonly arbitral tribunals, especially those in large financial centres, based upon impartiality and market practice considerations.

**Events of default:** These are the events that entitle the lenders to seek early repayment and cancel any undrawn commitments. The most common events of default are set out in the box below. Like the other provisions of the loan agreement, they will need to be considered carefully, especially the cross-default/acceleration clause which interconnects all of the sovereign's debt. In particular, the definition of the perimeter of the debt which cross-defaults/accelerates a loan (or indeed any other debt), will require careful attention.

### Events of default usually include the following:

1. Non-payment (of principal or interest) is subject to a short grace period to remedy the non-payment.
2. Breach of borrower's other obligations under the loan contract, subject to cure periods where the breach can be remedied.
3. Misrepresentation or breach of warranty.
4. Cross-default (an event of default occurring in another debt instrument) or cross-acceleration (an acceleration or enforcement by creditors under another debt instrument), in either case, is subject to a certain threshold and also with respect to specified debt instruments.
5. Overall payment moratorium.
6. Borrower's repudiation of the loan.
7. Judgment against the borrower for the payment of an amount over an agreed threshold.
8. Illegality (the adoption of any applicable law, rule or regulation which would make it unlawful to comply with the obligations agreed under the loan).
9. Loss of IMF membership or ineligibility to access IMF financial assistance.

## Sovereign (or "State") Immunity

Sovereign (or more correctly "state") immunity is an international law doctrine according to which a sovereign cannot be subjected without its approval to the jurisdiction of another sovereign. It covers immunity from (a) jurisdiction to hear disputes, (b) jurisdiction to recognise foreign judgments/awards, and (c) enforcement and execution of judgments/awards. As the doctrine is one of international law, how it is applied will depend on how each sovereign country and its courts have chosen to apply it. Some countries apply the doctrine in an absolute way without exceptions. Some other countries and jurisdictions (including the US and UK) apply the doctrine in a restrictive way and will not, in most circumstances, allow immunity to protect another sovereign for its commercial acts or in respect of its commercial assets.

In the context of raising debt, sovereign borrowers will almost always be asked to waive their rights to invoke any type of immunity in respect of proceedings relating to their debt obligations and to expressly confirm that these acts are commercial. The scope of this waiver can be negotiated, within limits.

Sovereign (or "state") immunity is a highly technical and complex legal topic and potentially involves a number of different jurisdictions. Even if sovereign immunity is not contractually waived, enforcement may still be possible if the competent courts determine that the assets are the property of the sovereign, but are held through an intermediary.

Seeking proper legal advice regarding the scope and implications of waivers of sovereign immunity is critical to sovereign borrowers to mitigate potential risks.

## Sanctions, Anti-Corruption, Anti-Bribery, Anti-Money Laundering and Anti-Terrorist Financing Laws

No debt raising is possible without consideration of a host of legal regimes on sanctions, anti-corruption, anti-bribery, anti-money laundering and anti-terrorist financing.

Financial and trade sanctions are used by international organisations and government bodies to discourage regimes or individuals from acting in ways generally condemned by the international community or individual nations by means of prohibiting certain transactions. Sanctions may take the form of targeted financial restrictions, such as asset freezing or "blocking" regimes, and/or more comprehensive export/import controls on goods, technology and services such as embargoes on commercial trade activity and transport. Sanctions can target either specified individuals and entities, industry sectors or entire countries.

Sanctions law is distinct from anti-corruption, anti-bribery, anti-money laundering and anti-terrorist financing laws. These laws target categories of unlawful behaviour by prescribing specific acts of corruption, bribery, money laundering and terrorist financing each as defined in the relevant laws of each of the international organisations and government bodies promulgating these laws as well as international standards.

The way all these laws are enforced is through penalties, not only on the persons engaging in the proscribed activity but also on a number of others who are considered facilitators, enablers or intermediaries. International institutions providing or arranging finance to sovereigns will almost always be subject to a number of such legal regimes and will therefore want to ensure that they do not breach any of their provisions. They will do this through their own diligence investigations and reliance on the sovereign's representations and ongoing undertakings. Their focus will not be solely on the specific transaction but on the laws of the sovereign, the way these laws are implemented and the ongoing commitment of the sovereign to participate in efforts to eliminate any such unlawful activity. If these institutions are not satisfied, they are unlikely to assist the sovereign in the raising of its finances. This in turn makes the overall efforts of the debt manager to raise and manage the finances of the sovereign more difficult and probably more expensive.

## A Note on Blended Finance

Blended finance refers to the strategic use of public, private and philanthropic capital to mitigate risks and to catalyse private sector investments in areas such as renewable energy, infrastructure, healthcare, education and agriculture, thereby accelerating progress towards the SDGs.

Blended finance mechanisms may include guarantees, grants, concessional loans, equity investments or other innovative financial instruments to attract private sector participation in projects that may otherwise be deemed too risky or financially unattractive.

Effectively deploying blended finance requires strong partnerships between governments, development finance institutions, multilateral organisations, philanthropic entities and private sector investors to ensure alignment of interests, transparency, accountability and measurable impact.

# 9 Sovereign Bonds

Bonds are tradable debt securities, often listed on one or more domestic or international stock exchanges. Bonds offer sovereign borrowers an alternative financing option to loans and the possibility of reaching a broader universe of prospective investors. Investors in bonds provide financing to the issuer for a fixed period of time. In return, investors expect to receive an interest payment, usually calculated by reference to a fixed "coupon" (a specified percentage) of the face value of the amount of the bond. Repayment of the principal of the bond occurs either upon maturity in a single payment (also known as "bullet" payment) or pursuant to an agreed amortisation schedule.

When bonds are issued, they can be privately or publicly offered to investors. If they are offered to a limited group of investors, this is referred to as a "private placement". If they are publicly offered, this is referred to as a "primary market" issue. Once the bonds have been issued and allocated to investors, any subsequent trading will take place in what is known as the "secondary market". Payment clearance and settlement of secondary market trading is completed via international clearing systems such as Euroclear, Clearstream and (in the case of bonds sold via Rule 144A) DTC.

Bonds can take many forms. Eurobonds, for example, were originally defined as bonds issued outside the domestic market of the currency in which they were denominated. The use of the term has broadened to encompass international issuances generally and so its current definition is that of an issuance in a currency other than that of the issuer.

Bond structures continue to evolve to allow issuers to reach an even more diverse investor universe and achieve specific sovereign objectives. Examples include:

**Commodity-linked bonds:** Bonds whose value is directly tied to the price of a specified commodity.

**Inflation-linked bonds:** Bonds which will protect the investors against the risk of greater-than-predicted inflation eroding their investment returns.

**Green bonds:** Bonds where the use of proceeds is specifically earmarked to finance or refinance projects with environmental benefits, such as renewable energy, energy efficiency, sustainable agriculture or clean transportation.

**Blue bonds:** Bonds where the use of proceeds is to finance projects focused on the conservation and sustainable use of marine resources, including initiatives related to ocean health, marine biodiversity and coastal resilience.

**Social bonds:** Bonds that are issued to raise funds earmarked for projects or programmes that address or mitigate social issues, such as healthcare, education, affordable housing or community development.

**Sustainable bonds:** Bonds aiming to finance projects that generate positive environmental and social impacts while also contributing to broader sustainability objectives such as sustainable development goals.

**Sustainability-linked bonds (SLBs):** Bonds that tie certain financial terms, such as interest rates or principal payments, to the issuer achieving pre-determined sustainability targets, encouraging the issuer to improve their environmental, social or governance performance over time, as measured by pre-agreed key performance indicators.

## Bond Pricing

Several factors have a direct impact on the pricing of bonds, including:

### CREDIT RISK

The price of a bond in both the primary and secondary markets depends on the perceived credit risk of the issuer. If the market believes that the issuer will have the capacity and willingness to pay its obligations in full and on time over the term of the bond, the market price of the bond will reflect this confidence. Conversely, if the market believes that the issuer may have difficulty (for whatever reason) meeting its obligations over the term of the bond, the market will demand a higher return for that risk. Perceptions of credit risk will vary over the term of the bond. Such changes in perception, together with market movements in the base rate of the currency of the bond, will affect the yield of the bond, through changes in the trading price of the bond over or below its face (par) value.

## MATURITY

In addition to the perceived credit risk of the issuer, as described above, the maturity of the bond, i.e., the duration of time before the bond issuer must repay the principal, is also significant. Investors generally demand a higher return if they are holding the bond over a longer period of time because they will be exposed to a potential credit risk for longer. An inverted yield curve may indicate debt repayment difficulties in the near future.

## INTEREST RATE

The interest rate on the bond will be determined at issuance based on the perceived credit risk of the issuer, the prevailing bank lending rate and the expected inflation over the term of the bond at the time of the issuance. The interest rate on a bond can be fixed, floating or indexed.

The nominal interest rate paid on the nominal amount of a bond is called its "coupon". It has to be distinguished from the effective interest rate on the bond, called "yield", which is calculated by reference to the trading price of the bond (at any time above or below par), its maturity and its coupon. For example, if a bond has a USD 100 principal value, a remaining maturity of one year and a 3% coupon, but is currently trading for USD 90, then the current yield is 3.33% (coupon/current price, which is higher than the coupon rate). As a result, even though the bond has a fixed coupon rate, the current yield will fluctuate as the bond price changes over time.

Some bonds are issued without any coupon (called "zero coupon" bonds). They are issued at a discount to their face value, to compensate for the lack of interest payments. For example, a short-term paper with a nine-month maturity (e.g., a US Treasury Bill) that includes a promise to repay the bill holder USD 1,000 in nine months, may be sold for USD 975, which results in an effective return rate of 2.5% if the bill is held until maturity.

### BOND PRICES OVER TIME

As bond prices change continually thanks to their ongoing trading on secondary markets, bond price trends can vary over time, depending on, for example, shifting investor perceptions of issuer creditworthiness, fluctuations in global interest rates and competing investments. In extreme cases, bond price volatility can be significant. For example, a bond that was originally issued at par at USD 100 may end up being discounted as low as USD 5 if investors believe that there is virtually no likelihood of repayment. The reverse is also true, as a bond price may rise if investor confidence in the issuer has increased.

## Key Bond Clauses

Many of the contractual provisions of commercial loans are also common to bonds (i.e., payment, negative pledge, the event of default, sovereign immunity and governing law and jurisdiction). The following provisions are noteworthy:

### PARI PASSU

This clause, as described above in the Chapter "*Commercial Loans*", was at the heart of long and controversial litigation before the New York courts. The dispute centred on the interpretation and application of the clause (as written in the Argentine bonds) concerning the ranking of creditors was ultimately resolved. To avoid any future debate and confusion, the International Capital Markets Association (ICMA) has published a template of this clause which refers to ranking and explicitly excludes rateable payments. It has become the market standard and sovereign debt managers are advised to follow the ICMA guidance.

### COLLECTIVE ACTION CLAUSES

The tradeable nature of bonds means that any single bond series has a disparate and anonymous investor community. The sovereign knows the lenders in a loan agreement, whereas it does not know the identity of the owners of its publicly-issued debt securities. This means that the interaction of the sovereign and its creditors to agree to amendments to the bonds has to be done more formally, as prescribed in the terms and conditions themselves.

At the core of the amendment mechanism of bonds are the collective action clauses (CACs). These provisions allow the sovereign issuer to propose changes to its bondholders, who are then able to vote on them. Changes relating to any of the terms and conditions can become effective and bind all the bondholders if accepted by the contractually-defined bondholder majority.

CACs have existed in English-law-governed contracts since the middle of the 19th century. For historical reasons, they had not been common in New York-law-governed bonds until recently. The latest such CACs, as set out in ICMA's model wording, offer a menu of voting procedures, including allowing the sovereign issuer to ask all its bondholders (or any group among them) across series to vote on changes to their bonds as a whole. The enhanced CACs make it easier to effect global amendments to a sovereign's bonds, including amendments on key terms such as maturity date, level of coupon and nominal amount repaid.

## DEBT PAUSE CLAUSES

Although not yet commonplace, debt pause clauses are contractual provisions that provide automatic stabilisers in the event of a predefined exogenous shock to the country, such as a natural disaster/climate event or pandemic. It allows a sovereign borrower to suspend principal and/or interest payments following the trigger event defined in the debt document. The ability to suspend debt service for a pre-agreed period of time gives the sovereign breathing room and permits it to redirect freed fiscal resources to the disaster response. Furthermore, following a catastrophic disaster event, public finances may become strained, aggravating liquidity problems that can lead to a default. Thus a debt pause may reduce the chance of a default and disorderly restructuring.

A subset of debt pause clauses, climate-resilient debt clauses (CRDCs), provide a potential crisis response tool for climate-vulnerable countries. The scope of organisations using and promoting CRDCs has expanded and now includes multilateral development banks such as the World Bank and official bilateral lenders such as the United Kingdom (through UK Export Finance) as entities integrating CRDCs into their lending instruments. For example, the World Bank currently offers CRDCs to IBRD and IDA Small State Economies, members of the Small States Forum and Small Island Developing States as defined by the UN. Other multilateral and official bilateral creditors are exploring the use of CRDCs.

From a debt management perspective, the “pause clause” provides temporary debt service relief and not debt cancellation or forgiveness, and as such, full repayment will still be required under the terms of the debt agreement. Depending on the terms agreed, deferring interest and other charges may result in these deferred amounts accruing contractual interest, which will increase the post-deferral debt burden of the sovereign borrower. Debt management officials must therefore weigh the costs and benefits of whether and when to trigger these clauses, as triggering may result in heavy bunched repayments that can upset a calibrated debt maturity profile and in turn lead to debt sustainability challenges.

These clauses can also be integrated into loan documents.

## Eurobond Issuance

There is a well-established process for the issuance of Eurobonds. The structure, legal documentation, target investor market, nature of the parties involved and market conditions can all influence the issuance process. The duration of the bond issuance process is also variable and can take more time if this is the first bond offering (known as a debut or inaugural issue for the issuer) or involves sales to investors in the United States or other jurisdictions with highly developed investor protection laws. A debut offering may require several months from start to finish, while a follow-on offering by a repeat bond issuer can be accomplished in a matter of several weeks. Offerings which require more detailed disclosure on the part of the sovereign issuer may require longer periods.

This chapter introduces the key parties involved in the bond issuance process and describes their roles. This is followed by a description of the main documentation required in bond issuances. This, in turn, informs the bond issuance process, as references are made to the different parties and the required documents during the different steps of the process.

### PARTIES INVOLVED IN A EUROBOND ISSUANCE

The key parties involved in a bond issuance, and their roles, are summarised in the following tables:

TABLE 6. Parties Involved

| Arranger | Manager (s) | Financial advisor | Guarantor | Registrar |
|---|---|---|---|---|
| Develops the bond issue structure, size, and terms, based on the issuer's needs. Organises investor roadshows and investor presentations based on the prospectus. Appoints legal counsel to draft underlying legal documentation. | Works with the arranger in preparing the bond issue. Undertakes initial purchase and placement of bonds. | Independent advisor of the issuer who advises on all aspects of the bond issue process including the selection of arrangers/book runners, managers, place of bond listing. | A third party guarantees totally or partially the payment of coupons and repayment of principal. | Holds the register of holders of the bonds. |

| Listing agent | Credit rating agency | Transfer and paying agent | Calculation agent | Legal counsel | Process agent |
|---|---|---|---|---|---|
| Only relevant for bonds listed on a stock exchange. Advises the issuer on the requirements and procedure for listing the bonds. Liaises with the stock exchange on submission of all necessary documentation for listing the bonds. | Assesses the creditworthiness of the issuer and assigns a rating to its bonds. Usually: Fitch, Moody's or Standard & Poor's. | Only relevant for registered bonds. A third party that facilitates change in ownership when bonds are transferred, bond repayments, and coupon payments. | A third-party agent is responsible for making required calculations for determinations under the bonds, e.g., to calculate an interest rate. | Each of the sovereign and the arranger appoints its own legal counsel to draft and settle legal documentation, conduct due diligence, prepare the prospectus, and issue legal opinions. | It is required to appoint a process agent to act on behalf of the issuer when a bond is governed by English law and there is submission to the English courts, to allow service of process in England in the case of a dispute. |

## CRITICAL DOCUMENTS IN A EUROBOND ISSUANCE

A bond issuance requires a substantial amount of preparation. A number of documents are required for bond issuances, whether offered through a widely marketed public offering or a private placement. The main documents involved in bond issuances are summarised below, together with a brief explanation of their purpose:

TABLE 7. Main Documents

| Mandate letter | Subscription agreement | Fiscal agency agreement or trust deed | Preliminary prospectus |
|---|---|---|---|
| The issuer mandates an investment bank to arrange the issuance of debt. | A document that states the terms that govern the manager-issuer relationship. Establishes the conditions under which the manager would buy or procure investors to buy the issuer's bonds. | The fiscal agent represents the issuer's interests and aims to fulfil the payments of the issued bonds, maintain records of payments, etc. The trust deed regulates the relationship between the trustee (usually a financial institution) and the issuer. The trustee represents and acts in the best interests of the bondholders. | This is the finalised advanced version of the Prospectus produced by the sovereign issuer, providing information about the issuance to give to investors used for the roadshow. Only the pricing information is still subject to confirmation. |

| Final Prospectus | Terms and conditions | Global bond | Legal opinions | Interest hedging agreement | Process agent agreement |
|---|---|---|---|---|---|
| The final offering document for the bond issue, submitted for the bonds to be listed. Customarily the only difference with the Preliminary Prospectus is the inclusion of the pricing information and dates. | The terms and conditions are set out in the Prospectus and contain the key commercial terms between the issuer and the bondholders (negative pledge/events of default/governing law/sovereign immunity, etc.). | The bond representing the entire amount of the issuance. Includes the main features of the bond issuance. | It is a usual requirement to obtain legal comfort that: (a) the sovereign issuer has the capacity and power to issue the bonds and that they are a legally binding obligation of the issuer; and (b) the English / New York law bond agreements are legal, valid and binding. | The issuer may enter into an interest or cross-currency swap to mitigate the interest or currency risks of the bond. | An agreement where the issuer appoints someone to act as a process agent in England (the governing law of the bonds). In the case of sovereigns, it is common to appoint the Ambassador or the Commercial attaché in England. |

## STAGES OF EUROBOND ISSUANCES

The following is a description of the typical five phases of a bond issuance: (1) pre-launch; (2) marketing; (3) pricing; (4) closing; and (5) post-issuance.

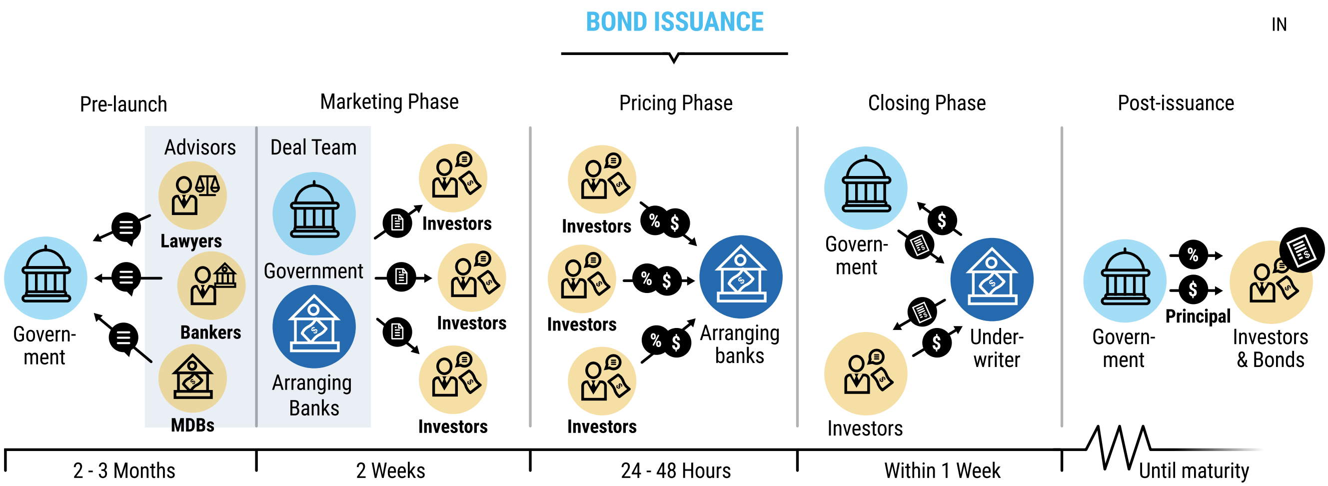



FIG. 3. Five Phases of Bond Issuance

## PRE-LAUNCH

The sovereign is usually well advised to appoint a financial advisor (independent of the role of lead manager/arranger) to work with it on all preparatory aspects of an international bond issuance. The work of the financial advisor involves advice on the selection of bookrunners, arrangers and managers, in compliance with local procurement laws. At the appropriate time, the sovereign will also need to appoint legal advisors to assist with the documentation, disclosure and bond issuance process.

The pre-launch phase starts when the sovereign bond issuer formally appoints, by means of a mandate letter, one or more lead manager(s)/arranger(s) to underwrite a new issue of bonds. The issuer will also select a paying agent and a trustee (or fiscal agent) for the issuance. The lead manager/arranger will appoint lawyers to act for them, will coordinate with the stock exchange where the bonds will be listed (if relevant) and will liaise with the sovereign issuer and its legal advisors to prepare the bond documents (including the prospectus/offering circular). At this point, the entire issuance team is working intensively with rating agencies, financial advisors and others to settle all legal documentation to allow for the announcement of the deal to the market.

Where the sovereign is seeking some form of credit enhancement from a guarantor, such as a multilateral development bank, to improve the risk profile of the bond, the sovereign issuer will also need to involve the guarantor (and its advisors) at a very early stage.

## MARKETING PHASE

Once the bond documents are essentially finalised and in the agreed form, the lead manager/arranger announces to the market that they have been mandated to arrange a series of meetings between the issuer and the investors usually in key investment centres (often described as a "roadshow") in person or virtually (post-pandemic). The "preliminary prospectus" is used for these roadshow meetings with investors. A roadshow usually lasts for four or five days.

## PRICING PHASE

The pricing phase immediately follows the roadshow where the lead manager/arranger invites investors to indicate the commercial terms (coupon, issue price, yield and maturity) and amount of bonds that they would be prepared to purchase. Based on this feedback, the lead manager/arranger builds a "book" of orders for presentation to the issuer. The issuer then determines the size, pricing and maturity of the bond offering based on this investor feedback and the lead manager/arranger communicates this decision to the investors who have indicated interest in the bonds.

### CLOSING PHASE

After pricing, the lead manager/arranger and the issuer sign a subscription agreement that legally binds the managers to subscribe for the offered bonds on the date of financial closing (which normally occurs five days after pricing). Based on the book of orders, allocation of the bonds are made to investors by the lead manager/arranger and investors are asked to enter into a binding agreement on the amount of bonds they are willing to buy on the closing date. At closing, all parties involved in the issuance execute their respective agreements and the bonds are formally issued and delivered by the sovereign. The listing of the bonds on the selected securities exchange occurs and the rating is confirmed by the chosen credit rating agency. The issuer receives the cash proceeds of the bond offering from the lead manager/arranger (who has in the interim collected the payment monies from investors to whom bonds were sold) and investors have bonds credited to their securities accounts in the international clearing systems. Closing is then deemed to have occurred.

### POST-ISSUANCE PHASE

In the post-issuance phase, the issuer pays the bondholders the periodic interest and principal due under the contractual terms of the bonds until maturity. This is done through the paying agent.

## SPECIAL CONSIDERATIONS IN THE ISSUING PROCESS

This section provides a brief overview of certain specific aspects of the bond issuance process that require special consideration. These are the preparation of sovereign disclosure, due diligence, the listing process, the rating requirements and the underwriting process.

## SOVEREIGN DISCLOSURE

When a sovereign accesses the international debt capital markets, it must prepare and include in the prospectus a description of the country to enable potential investors to make an informed investment decision. This description will cover a variety of matters, including an overview of the political system, a description of the economy and its key sectors, an overview of monetary policy and the banking system, data on the balance of payments, budgetary information and sovereign debt. There will also be a section describing material risk factors that should be borne in mind by investors when considering an investment in the bonds.

The preparation of the sovereign disclosure will be time consuming and require gathering of information from many different sources and institutions within the government. The coordination of the information-gathering process is usually handled by the Ministry of Finance, but the selected legal advisor for the issuer normally "holds the pen" when drafting the disclosure included in the prospectus, possibly assisted by the financial advisor. Usually, multiple iterations of the sovereign disclosure will be prepared before it is in final form. These iterations will reflect, among other things, comments received from the banks acting as managers of the offering process. The final scope and content of the sovereign disclosure will be subject to the approval of the listing authorities before the bond offering is completed.

## DUE DILIGENCE

The banks selected to act as managers of the offering will be exposed to legal and reputational risks in connection with the offering and sale of the bonds to investors. Should there be material errors or omissions of material information in the prospectus, the managers may have liability toward investors who purchase bonds in the market. To minimise these risks, the managers will usually insist upon a process for verifying the factual information in the prospectus and ensuring that all material factors have been properly addressed. This will generally include a "due diligence" meeting, which can take a few hours to as much as a day or two, where the managers and their legal counsel have an opportunity to ask questions of representatives of the government. This process can be surprising for issuers who have not previously accessed the debt capital markets, but is a normal and necessary process. The financial and legal advisors of the issuer will also attend the due diligence meeting and will be available to provide guidance and answer questions the sovereign may have about the process.

## LISTING OF BONDS

To obtain optimal terms and pricing, issuers typically seek to target as large a universe of prospective investors as possible. As part of maximising the market for a bond offering, most international sovereign bonds are listed on a securities exchange. The listing procedure of the exchange, which normally involves obtaining the approval of the content and substance of the prospectus from a regulatory authority in the jurisdiction where the exchange is located, may also provide an extra sense of security to investors.

The most common stock exchanges targeted in these issuances are London, Dublin, Luxembourg, New York and Singapore, but of course, this will depend on the targeted investors. In recent years, London has been a particularly popular jurisdiction for listing of sovereign Eurobonds because of rule changes exempting sovereigns from compliance with prospectus rules, substantially reducing the burden associated with the listing process.

Needless to say, the listing process can take time, which presents challenges for sovereigns seeking to capitalise on windows of opportunity in a fast-paced market. A common practice to shorten listing time is to proceed with a "shelf registration" or debt programme establishment that allows splitting the issuance into multiple issuances. The sovereign can forecast longer-term financing needs and do a shelf registration/establish a debt programme for an amount higher than its actual debt-raising needs (e.g., double or triple the amount to be issued) and then, dependent upon future needs, proceed to issue a new series of bonds without the burdensome requirements of a full issuance registration.

Another practice to facilitate speedy access to capital markets is to proceed with a private placement. In a private placement, the bonds being issued are allocated through a private offering to a single or a small number of investors (i.e., not through a public offering). This placement takes place outside of a securities exchange, although it may still require significant structuring, legal input and diligence to generate investor confidence in the bonds and to comply with all relevant securities laws (in particular for private placements to investors in the U.S.).

## RATING OF BONDS

As part of the issuance process, bonds are usually rated by international credit rating agencies (CRAs) which are independent companies acting upon the request of the uer to assess the creditworthiness of the issuer and its financial instrument. These independent companies seek to reduce "information asymmetry" by analysing the probability of default for the bonds issued by a sovereign. Three CRAs dominate the international rating market: Fitch Ratings; Moody's Investors Service Limited; and Standard & Poor's Rating Services.

## BOND UNDERWRITING

When a bond is being issued in the primary market, the sovereign issuer will employ the services of one or more investment banks to act as lead manager(s) or arranger(s) of the offering. The lead manager/arranger plays a key role in coordinating the issuance, marketing, book-building and documentation process and will assume certain underwriting risks in connection with the initial placement. Specifically, it will (1) assist the issuer in determining the financial terms and timing of the proposed issuance; (2) use its best efforts to distribute the bonds to investors in the selected markets; and (3) agree in certain circumstances to buy such bonds from the issuer in case the distribution is not successful in whole or in part.

In general terms, underwriting refers to the process whereby the lead manager/arranger secures commitments from investors to purchase bonds of the issuer in connection with a primary offering. Different underwriting structures may be agreed upon with the underwriting banks, with different commissions paid to the banks involved to compensate them for the magnitude of commercial risks they are assuming. In short, underwriting involves:

Level 1: Using best efforts to place the bonds but with no commitment to purchase bonds that are not taken up by third-party investors, which offers minimal risk to the underwriter and hence lowest underwriting commissions.

Level 2: Subscribing for any unsold bonds in the primary offering, which offers a greater degree of risk to the underwriter, who may end up with a sizeable amount of debt on its books depending on the success of the offering and hence higher underwriting commissions.

Level 3: Subscribing for the entirety of the bond issuance with a view to selling the bonds later (at its own risk) to third-party investors, which entails the highest degree of risk and the highest level of underwriting commissions for the underwriter.

These three levels are illustrated in the diagram below:

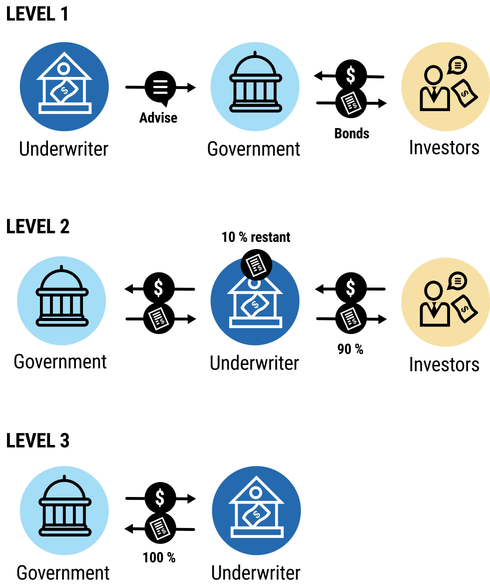



FIG.4. The Three Levels of Underwriting

# 10 Secured Lending

Most sovereign borrowings (e.g., through loans or bonds) or other financial exposures (e.g., through guarantees, counter-guarantees or indemnities) are unsecured. This means payment of the financial obligations relies on the overall faith and credit of the sovereign obligor who will, in turn, rely on its tax-raising resources and assets to pay the obligations. Occasionally, creditors will demand the sovereign obligor to set aside a particular asset ("collateral") to satisfy their claims in the event of nonpayment. This collateral can take a variety of forms, including real estate, bank accounts, gold reserves, future tax revenues, tolls collected for the use of an infrastructure project, future outputs of commodities (such as oil or gas) and receivables from the sale of such commodities. The granting of any security by a sovereign should be approached with great caution because it can have important policy implications and legal repercussions.

Secured lending is an increasingly popular financing tool for African sovereigns. This form of lending has benefits and drawbacks. Benefits include lower interest rates (as compared to unsecured lending) and access to new creditors and sources of financing. Drawbacks include potential loss of control of strategic state assets and complications to debt restructuring.

Secured debt financing can take many forms and will depend either on the type of security asset or the form of financial instrument used. For example, real estate can be provided as security by way of a **mortgage**. The mortgage creates what is sometimes called a "classic security interest", which can be enforced if there is a default by the debtor. Other classic security instruments include pledges (typically for bank accounts and bonds) or security assignments (typically for receivables).

A **sale and lease-back agreement** is an example of an "effective" security arrangement. It involves the immediate transfer of title to real estate or tangible assets by the sovereign borrower to the secured lender at the outset of the transaction, with the lender immediately leasing the asset back to the borrower for a specified period of time. At the expiration of the lease, the title to the asset is transferred back to the sovereign borrower. A **repurchase agreement** (also called "**repo**") is another example of effective security, as it requires the borrower to sell an asset to the lender and leave it in the custody of either the lender or a third-party custodian. At the expiration of the repurchase agreement, the lender will have the obligation to sell the asset back to the borrower for a pre-determined price which will include an amount equivalent to the interest that would have been applied on an equivalent loan. This type of structure is often used for gold reserves, oil receipts or entitlements to future output.

**Limited recourse financing** usually relates to projects for infrastructure development or the development of energy assets. It is a secured financing tool linked to the asset or project being developed and limits the financial risk of the sovereign to the value or performance of that asset or project. In other words, even if the sale of the asset used to secure a limited recourse borrowing does not cover the outstanding balance of such borrowing, the sovereign debtor will not have the liability to cover the difference.

## Important Note on World Bank Negative Pledge

When the World Bank makes loans to or with the guarantee of a member country, it's General Conditions for Financing (as published from time to time) will apply to such extension of credit. The World Bank does not generally require security from the member country concerned in connection with such financing transactions. However, to protect the interests of the World Bank, the General Conditions include a negative pledge clause that strictly limits the ability of the member country to grant security in respect of foreign currency-denominated obligations in favour of other lenders without also securing the World Bank.

The scope of the World Bank's negative pledge is broad and covers not only "true" security interests such as pledges and mortgages, but also "privileges and priorities of any kind". Importantly, it also restricts the granting of security by SOEs of the member country concerned, which often creates issues for national oil companies and other large state enterprises who seek to borrow in the international markets. State-sponsored infrastructure and other projects financed in whole or in part from commercial sources need to be carefully structured to minimise the risk of breach. As a matter of policy, the World Bank rarely grants formal waivers of the clause. Other

MDBs including AfDB also include a negative pledge clause in the general conditions for their loans.

## Pre-Export Financing Agreements

Commodity-exporting countries, especially oil-exporting African countries, have increasingly resorted to pre-export financing agreements in recent years. The basic features of commodity pre-financing or pre-payment agreements can be summarised as follows. A trading company enters into a commercial contract with a commodity exporter (in most cases, the national oil company); the exporter commits to sell a predefined number of cargoes over a given period of time and the trading company commits to buying them at a price usually based on prevailing market conditions at the time of the sale following a predefined formula. The trading company is asked to pre-pay (i.e., finance) a fraction of the future cargo sale proceeds based on an agreed interest rate, payment frequency and maturity (usually in the form of a maximum authorised outstanding debt amount at each anniversary date). The resulting debt is then redeemed automatically every year by the allocation of a given percentage of each cargo delivery sale. This continues until the maximum authorised outstanding debt amount is reached.

In some respects, such arrangements have attractive features, in that they are easy and rapid to conclude, do not require heavy due diligence and usually include reasonable interest rates. However, there are also challenges associated with this type of arrangement. For example, the all-in cost to the sovereign often substantially exceeds the externalised interest rate, given the fees payable (arrangement fees, agency fees, etc.) as well as various clauses providing for step-up interest payments under various circumstances (late payments, default, etc.).

In addition, from a public finance perspective, these contracts may prevent the sovereign from accessing significant revenues when most needed.

Finally, in case of a drop in relevant commodity price or a downturn in its production, there is a high risk that the cargo available to the trader will not generate enough proceeds to repay the pre-financing. When this happens, mechanisms of interest rate hikes are triggered. This forces the renegotiation of the repayment amortisation schedule, with additional fees to be paid to the traders. All of this happens in a context where the country is at the same time severely hit by the decrease in available oil revenues.

For these reasons, the sovereign should always consider these agreements with care and ensure transparency from the national oil company when it enters into this type of agreement.

# 11 Shari'ah Compliant Sovereign Debt

There has been a significant increase over the past decade in the use of financial instruments structured to be compliant with Islamic law, also known as Shari'ah (the Arabic term for law). Shari'ah-compliant instruments can be an attractive source of funding for sovereign borrowers who prefer to raise Islamic-compliant financing or are seeking to market to investors for whom Shari'ah compliance may be mandated or preferred. Employing this instrument also presents an opportunity to reach a new pool of external investors and, where appropriate, develop local markets with domestic Islamic investors.

In general, Shari'ah compliance stems from prohibitions under Islamic financial law against the resale of debt contracts, the generation of profits without an associated economic activity and the use of financing to support prohibited goods/activities (i.e., alcohol, pork products, weapons, adult entertainment and gambling). From an economic perspective, Shari'ah-compliant financing differs from conventional lending in that the financier may only earn profits through participation in the activity that is being financed, and even then, only if the investment produces a profit.

## Main Principles of Shari'ah-Compliant Finance

The main principles of Shari'ah-compliant finance are:

1. 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.
2. Speculation is not permitted and contracts involving it are void. Commercial transactions and the attendant commercial speculation are permitted, but the line is drawn (not always an easy task), on speculation which, like gambling, does not depend on productive effort.
3. Unfair contracts leading to unjust enrichment are void. What is unfair and exploitative is not always easy to identify 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.
4. Commercial arrangements which may otherwise be permissible are only permissible if the assets which are the subject of these arrangements are themselves permissible.
5. Contracts with uncertainty, such as insurance contracts, are void.
6. Emphasis should be on activities in the real economy and on the sharing of risks and rewards.

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

Of note, the application of these principles may introduce legal uncertainty as to whether any specific transaction is within the bounds of Islamic law. For any financial transaction that aspires to be large and scalable, this uncertainty needs to be resolved. Islamic banks have been addressing this challenge by establishing boards of Islamic law experts grouped in Shari'ah boards who review the proposed transactions. In addition to reviewing individual transactions, these Shari'ah boards have been developing general Islamic law and policy. The result is increased legal certainty, which has allowed the markets to grow.

## Types of Shari'ah-Compliant Finance Instruments

There are many types of Islamic finance instruments. However, the types most likely to be used by sovereigns include Sukuks, reverse Murabahas (Tawarruq), Musharakas, Mudarabas and Ijaras.

- **Sukuks:** The most common instrument at present is the Sukuk (meaning "certificate of ownership"), which is similar to asset-backed bonds. The general structure of a Sukuk requires that the funds generated by the sale of the instrument be placed in a special-purpose vehicle (SPV), after which the SPV will invest in Shari'ah-compliant activities. The investors in the Sukuk will then share any profits generated by the portfolio of investments held by the SPV, such as through profit-sharing of a corporate investment or lease proceeds from investment in real property. Sukuk certificates will be issued under similar diligence standards as sovereign bonds, including relying on a rating by CRAs. Particular care should be taken on the first issuance of Sukuks to align collective action clauses with existing debt issuances — please see the box "*Two Important Considerations for Debt Managers*" in the Chapter "*Debt Management Strategy*" and the ALSF Debt Guide mentioned below.

- **Murabahas**: Murabahas (meaning "trade with markup") are used instead of loans. These structures vary but in essence, replicate the following pattern: at the same time, the actual borrower sells goods to the actual lender for 100, with immediate settlement, and sells the same goods for more than 100 (say 120) back to the actual borrower on deferred payment terms.
- **Musharakas:** In a Musharaka (meaning "sharing" or "equity participation" contract), different parties contribute capital, profits are shared according to a pre-determined ratio and losses are shared in proportion to capital contributions.
- **Mudarabas:** Mudaraba (meaning "a trustee financing contract" where the bank provides the capital and the other side provides labour). One party contributes capital while the other contributes effort or expertise. Profits are shared according to a pre-determined ratio and the investor is not guaranteed a return and bears any financial loss.
- **Ijaras:** Ijaras (meaning "financial lease contract") are structured like leases, with the rental payments calculated in advance as fixed payments.

For more detailed information about Shari'ah-compliant borrowing, including structures, objectives and principles, please see the ALSF Debt Guide on Key Considerations for Incurring Non-Traditional Debt.

# Sovereign Debt Management

# *Key Points*

*Sovereign debt and its prudent management through appropriate institutions are essential for the functioning of a sovereign and the welfare of its citizens.*

*Effective sovereign debt management ensures that the government's financing needs are met with a prudent degree of risk and its payment obligations are optimised over the medium to long term, consistent with its public policy objectives.*

*Ensuring proper recording, reporting, monitoring and accounting of sovereign debt data, and maintaining prudent and reliable projections of debt and economic indicators, are key responsibilities of debt management.*

*A coherent debt strategy that assesses related costs and risks of financing options is critical for responsible borrowing decisions. Any strategy must also ensure that the chosen debt instruments include terms that facilitate efficient liability management or restructuring.*

*A well-designed debt strategy with long-term horizons can contribute to the development and maintenance of efficient and deep domestic credit and capital markets.*

*Debt management tools and resources produced by the IMF and World Bank are available to assist countries in improving debt management.*

# 12 Rationale and Overview of Sovereign Debt Management

Countries raise debt to cover fiscal deficits and to finance a wide array of projects and programmes for the welfare of their citizens. This includes financing social spending such as health and education and productive investments that expand the country's economic potential such as infrastructure. More generally, all companies and businesses operating within the jurisdiction of a sovereign depend, to various degrees, on the ability of the sovereign to raise debt and its credibility to sustain it.

Sovereign debt is, therefore, vital for a country's economic development, and its management should benefit a broad range of stakeholders. As such, transparency and proper communication with all stakeholders, domestic and international, are important. Robust, transparent, and accountable debt management institutions serve collective trust and ownership.

Sovereign debt management is a process that requires the establishment and execution of a strategy for managing a government's debt. It aims at raising the required amount of funding at the lowest expense consistent with prudent risk management to meet the current financing needs of the government, including the repayment or refinancing of existing debt obligations. Debt managers must take into account a number of considerations when selecting the most suitable debt instruments for this purpose. These considerations include optimising debt servicing costs, achieving debt sustainability targets, and contributing to economic, fiscal and monetary policies. A sound and long-term debt management strategy will also help develop, maintain, and benefit from, an efficient, robust and deep domestic securities and financial market.

The scope of sovereign debt management should encompass all central and subnational government liabilities. Debt managers should also monitor contingent liabilities, whether explicit or implicit and the liabilities of undercapitalised SOEs.

At worst, poor debt management can impair a sovereign's fiscal sustainability, increase the risk of debt distress and adversely affect the assessment of outside stakeholders (investors, rating agencies and multilateral institutions).

Sound sovereign debt management can, at minimum, help lower a government's debt servicing costs, facilitate fiscal and monetary policy coordination, and contribute to fiscal discipline.

At best, sound sovereign debt management will also (a) promote economic growth and the growth of domestic credit and capital markets, (b) improve social outcomes by freeing up resources for social spending, (c) grow the government's revenue collection pools, (d) promote monetary and economic stability, (e) reduce risk to the government budget from changes in financial conditions and (f) help prevent debt distress. This gives confidence to all stakeholders, from external creditors to domestic businesses and the ordinary citizen, generating a virtuous circle.

## Governance Framework for Effective Sovereign Debt Management

This chapter examines the governance requirements for effective sovereign debt management, particularly the legal, regulatory and institutional requirements and policies that support effective sovereign debt management.

### LEGAL AND REGULATORY FRAMEWORK

Effective sovereign debt management must be supported by a well-defined legal and regulatory framework to facilitate the achievement of debt management objectives. There should be a comprehensive legal framework (at both central government and subnational levels) with a consistent set of laws reflected in a comprehensive public financial management act, or at a minimum, a sovereign debt act and fiscal responsibility laws. This legal framework may also include rules for public and subnational entities, including the processes that should be followed to guide their issuances of securities and other forms of borrowing. The legal framework should describe the steps necessary to establish the authorisation to borrow, undertake specific debt transactions and issue government guarantees on behalf of the central government. In addition, the legal framework should specify the approved types of financing and debt instruments available to the sovereign.

Ideally, an institutional framework will be established with rules and regulations for each institution involved in sovereign debt management functions and an associated set of operations manuals, procedures manuals and job descriptions for all the institutions and personnel involved.

### ESG-RELATED FRAMEWORKS

In addition to the general legal and regulatory framework, certain debt issuances related to ESG outcomes may require other frameworks targeted for those markets, e.g., a green bond framework. These frameworks are typically prepared by responsible government institutions working in collaboration with debt managers and other interested stakeholders.

A green bond framework fulfils several critical functions. Firstly, it provides clarity and transparency regarding how the proceeds from green bonds will be allocated towards environmentally sustainable projects. This transparency helps investors understand the environmental impact of their investments and fosters trust in the issuer. Secondly, a green bond framework helps standardise green bond issuances, ensuring consistency and comparability across different projects and over time. This standardisation reduces confusion for investors and allows for better evaluation of the environmental performance of green bonds. Thirdly, having a green bond framework can attract a broader investor base, including environmentally conscious investors and institutional investors with specific sustainability mandates. This expanded investor base can lower borrowing costs for issuers and increase demand for green bonds, thereby facilitating the financing of green projects. Finally, a green bond framework demonstrates a commitment to sustainability, which can enhance the issuer's reputation. Overall, a green bond framework is essential for debt managers to promote transparency, standardisation, investor confidence and sustainable finance.

Other frameworks, related to, blue, social and other sustainability bonds may also be developed where such instruments are being considered.

## SUBNATIONAL DEBT MANAGEMENT

Depending on the intergovernmental fiscal relation within a country, subnational entities may borrow in the domestic and international debt markets. This may include issuance by (a) subnational governments or political subdivisions (e.g., states within a federal system, provinces and/or municipalities) and (b) enterprises owned or controlled by the sovereign (SOEs such as electricity producers and distributors, water and waste management companies or national oil companies).

In fiscally decentralised governments, the subnational political organs may have constitutional and or legal powers to contract certain classes of domestic debts directly but are typically restricted from borrowing internationally. In such cases, the central government borrows and on-lends to the subnational governments. Additionally, the ability of subnational entities to raise debt is impacted and largely contingent on the ability of the sovereign to raise debt. There will be circumstances where the sovereign will have to assume the burden of subnational debt, either expressly through guarantees or implicitly, to preserve and provide the essential functions and services expected of the underlying entity.

Regardless of how it is done, the borrowing of subnational entities creates an additional layer of responsibility for debt managers: oversight at the national level and prudent debt management at the subnational level. For the national debt manager, the debt of subnational entities, although legally distinct from the sovereign, will need to be considered in any ongoing monitoring and assessment of the sustainability of the sovereign's debt.

Debt management at the subnational level must enshrine best practice principles described for central governments in this chapter, notably when it comes to ensuring that debts meet economic, social or other development objectives according to extant laws. Subnational entities must also implement comprehensive debt management strategies and follow the loan management cycle and due process necessary for their governance structure.

Key challenges to subnational debt management, as well as central sovereign debt management, lie with the ability of these entities to properly record, monitor and report their local debts, as well as the capacity and experience to incur debts on appropriate terms. Absent an appropriate framework, debts may not be transparently contracted or may be susceptible to political influence and the extent of risk associated with such debts is not easily determinable. Joint capacity-building initiatives for both national and subnational debt managers can improve the quality of the reporting, increase the information flow between the two levels of government and consequently reduce the risk related to subnational liabilities.

## INSTITUTIONAL FRAMEWORK FOR DEBT MANAGEMENT

Efficient debt management processes rely on a clear division of the responsibilities and accountabilities of each actor involved in debt management activities (as shown in *FIG.5.* Debt Management Governance Framework). A country's constitutional structure (parliament/congress/national assembly) will typically define the governance arrangements, including to which body the fiscal accounts are periodically presented. From such authority, the relevant powers for various debt management functions are granted to the Ministry of Finance/Council of Ministers and/or the Central Bank.

The organisational structure of a modern debt management office (DMO) is based on the separation of responsibilities between the front, middle, and back offices with distinct functions and accountabilities. In some African countries, these offices are consolidated in a single DMO, while in others, these offices are fragmented across the Ministry of Finance and the Central Bank.

Regardless of the institutional set-up, clarity of roles and responsibilities, policy coordination, information sharing, transparency, and accountability are critical for effective debt management.

## FRONT OFFICE

The front office is responsible for mobilising resources from both domestic and external sources at a minimum cost and in a timely manner. The front office typically implements the borrowing plan based on the debt management strategy (DMS) approved by the government; negotiates with creditors; liaises with market players; regularly reviews market conditions, and provides information to donors/creditors, international financial institutions, commercial banks, etc. This includes especially the credit rating agencies which will require regular engagement as part of the review process.

As an increasing number of African countries access the international capital markets regularly, investor relations (IR) is becoming a standalone and more important function of the front office, warranting specific attention. IR requires a holistic approach involving ongoing communication, marketing and compliance to foster effective dialogue between the sovereign entity and the financial community.

IR notably encompasses the maintenance of a dedicated website providing up-to-date financial and statistical data (please see the Chapter "*Recording, Reporting and Maintaining Good Debt Data*"), preparing regular investor presentations or conducting global investor calls. In-person engagement (deal or non-deal roadshows), different target geographies and investor types depending on the issuer's objectives. Roadshows will usually be facilitated by banks which can be appointed ad hoc or as part of a bond issuance process for deal-related roadshows.

### MIDDLE OFFICE

The middle office provides advice and analysis that enable the government to meet its financing needs at the lowest possible cost within a prudent level of risk. The middle office monitors the front office's compliance with the chosen strategy, cost and risk limits. It assesses and manages all types of risks — market, refinancing, liquidity, credit, operational and contingent.

Some examples of middle office functions include determining borrowing ceilings for the government consistent with fiscal and monetary policy requirements; formulating a debt strategy; providing reliable forecasts of debt servicing that inform fiscal forecasts; and performing debt sustainability analysis regularly. Monitoring contingent liabilities may also be a middle office responsibility.

### BACK OFFICE

The back office is responsible for debt registration, handling transaction confirmations, settlements, and payments, and maintaining accurate, up-to-date records of all debt contracts, disbursements, payments, debt restructuring agreements, on-lending arrangements, issued guarantees, settlement of transactions, etc. The back office is also responsible for providing projections of debt servicing and disbursements to inform the budget planning process.

### SOVEREIGN DEBT AUDIT

Public borrowing entails significant risks if not managed properly. Supreme Audit Institutions (SAIs) can significantly improve sovereign debt management and prevent sovereign debt from reaching unsustainable levels. Regular financial and performance (value for money) audits of sovereign debt are essential to guarantee sovereign debt managers are held accountable for their actions. Performance audits of sovereign debt can enhance the effectiveness of debt management, and provide greater transparency of the risks and benefits of sovereign debt.

SAI audit reports can improve debt management in the following regards: (1) enhancing sovereign debt transparency and accountability by examining current reporting practices; (2) strengthening internal control in sovereign debt programmes to reduce risks of fraud and corruption; and (3) modernising the sovereign debt legal framework by examining best practices identified in the International Standards of Supreme Audit Institutions (ISSAI) sovereign debt audit guidelines. SAI audit reports must be presented annually to the legislature and publicly available for general scrutiny.

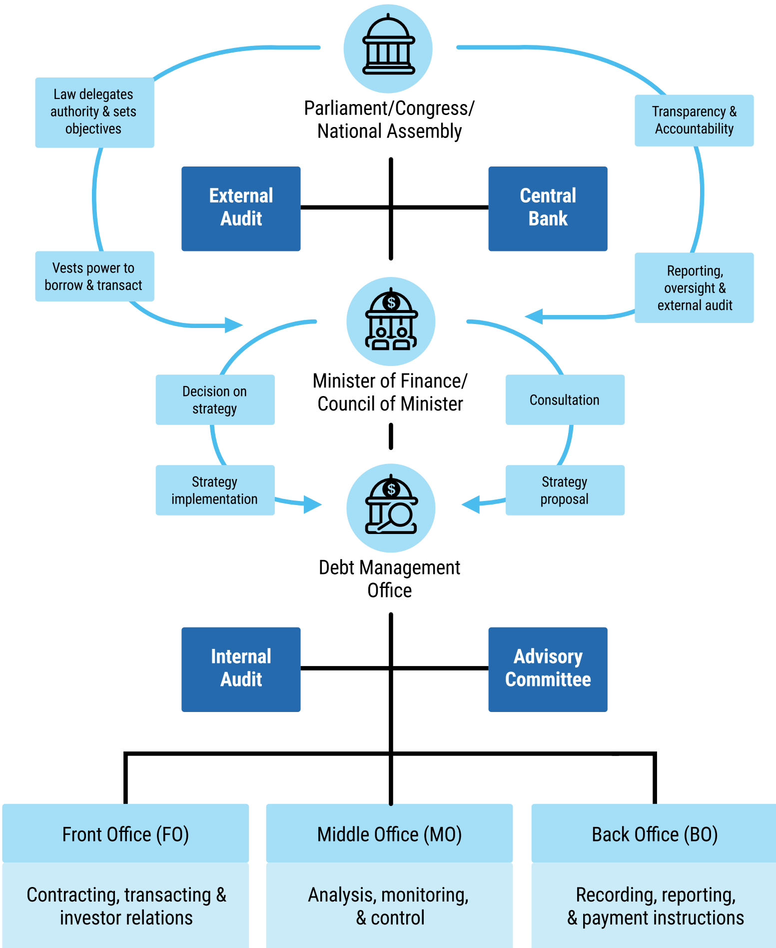



FIG. 5. Debt Management Governance Framework

# 13 Debt Management Strategy

A government's DMS is a medium-term plan that guides borrowing decisions, taking into account funding costs, risk preferences, and the country's fiscal and balance-of-payments constraints.

The DMS provides a framework within which the government can make informed choices on how best to meet financing requirements. Once a government has approved a DMS, the sovereign debt manager is empowered to take a disciplined approach in the pursuit and implementation of the DMS objectives.

The DMS must fit into the overall medium-term macroeconomic policy framework. An effective DMS will result from continuous coordination between the DMO and the relevant fiscal and monetary policy authorities (Ministry of Finance and the Central Bank, respectively).

Typically, the key objectives of a DMS are:

- To facilitate the raising of the required quantum of funding, from an appropriate mix of sources, to meet the government's financing needs.
- To minimise the overall cost of funding, consistent with an acceptable degree of risk.
- To manage the sovereign debt profile through proactive liability management.
- To ensure that payment obligations are met.
- To manage fiscal risks.

# Process for Developing a Debt Management Strategy

A formal DMS, once adopted by key stakeholders within the government, can help build broad-based support for responsible financial stewardship. To ensure transparency and accountability, the important features of the DMS should be communicated to key stakeholders (including legislators, local and international investors, rating agencies and the general public). It is good practice for the sovereign to review and update its debt management strategy on an annual or other regular basis and more frequently if macroeconomic or market conditions change significantly.

One of the key inputs required for the development of a sound debt strategy is the collection of accurate data on the total amount of debt outstanding (including SOE debt and contingent liabilities) and the terms and conditions of such debt (e.g., currency, maturity, interest rate and instrument type, governing law and use of funds).

The Medium-Term Debt Management Strategy (MTDS) toolkit developed by the World Bank and the IMF provides countries with a comprehensive and structured approach to the formulation of a debt strategy (see IMF, The World Bank 2019: Medium-Term Debt Management Strategy: Analytical Tool Manual). The key steps to be followed are:

1. Identify the objectives and scope of sovereign debt management. The relevant objectives for debt management are often framed as ensuring that the government's financing needs and payment obligations are met on a timely basis and at the lowest possible cost, consistent with a prudent degree of risk. A secondary objective can be supporting domestic debt market development.
2. Identify the current DMS and analyse the cost and risk of the existing debt stock.
3. Identify and analyse potential funding sources, including associated costs and risk characteristics, prevailing market conditions, and existing exposure to any particular source of funds.
4. Prepare a DSA reflecting baseline macro-financial assumptions of the government and various funding options, which will require close interaction with the relevant fiscal and monetary policy authorities.
5. Identify preferred funding options and discuss with fiscal and monetary policy authorities to secure consensus. Based on feedback, the debt manager may have to submit an alternative proposal for approval.

Annual borrowing plans (ABPs) are a key debt strategy implementation tool. ABPs provide granular details of how the government plans to meet its gross financing requirements based on available financing options. The ABPs should be in line with the developed DMS, be reviewed annually and must be duly authorised by the appropriate approving authorities (e.g., the Minister of Finance and or Parliament as the case may be) to enable the debt management office to operationalise the plans. The ABP provides useful information to investors and creditors to support the government's borrowing plans. Ultimately, it is a key tool to ensure debt transparency and sustainability. For sovereigns with a functioning domestic debt market, the ABP supports the development of periodic issuance calendars that specify the domestic instruments to be issued and provide market participants with upfront visibility.

## Managing Direct Financial Costs, Benefits and Risks

Prudent and sound debt management requires first and foremost an evaluation of the terms of the proposed debt instrument. All the cash flow provisions need to be scrutinised in detail:

- Net amount raised vs. amount due.
- Tenor of debt.
- Interest cost and periods.
- Other upfront fees or ongoing costs (e.g., arrangement, agency and commitment fees).
- Contingent costs (e.g., lender regulatory costs, breakage/unwind costs, margin step-ups related to covenants or related to lender cost of funding, liability for third-party expenses, etc.).
- Level of creditor commitment and conditions required for disbursement.

### BENEFITS

The benefits of the proposed debt arrangement need to be assessed along the following lines.

- Use of net proceeds from the debt issuance.
- Comparison of the cost-benefit across competing purposes for debt issuance.

- Specific attention to the monitoring of benefits of non-revenue-producing projects.
- Cash flow projections and match with out-flows for revenue-producing projects.

**RISKS**

In addition to the above direct financial costs and benefits, managing any debt portfolio assumes a number of direct financial risks that need to be addressed. The debt manager should also consider the sources of revenue that will be used to service and ultimately repay the debt obligation, bearing in mind the redemption profile of the existing debt portfolio. These financial risks must be carefully managed and monitored so that they do not expose the country to unexpected cost increases.

Examples of such financial risks are:

- **Market risk:** Adverse changes in market conditions (e.g., interest rates, foreign currency exchange rates or commodity prices) can increase debt servicing costs or missed opportunities to reduce such costs.
- **Refinancing risk:** When refinancing existing or maturing obligations, there is a risk that market access could be limited or only available at higher rates.
- **Liquidity risk:** It might not be possible to sell an obligation promptly or cost-effectively.
- **Counterparty credit risk:** A counterparty might fail to make the required payments on time or in full.
- **Operational risk:** Poor recording, unverified data or other errors that could occur when transferring data from one system to another, as well as fraud, could result in under or overpayment of obligations.

### Questions for debt managers when assessing direct financial benefits of debt issuance

- How are the net proceeds of the debt to be applied? Are they to cover a fiscal deficit, to fund a particular social goal, to fund an SOE or other third party or to fund a development project or other revenue-producing project?
- What is the cost-benefit evaluation of the chosen purpose among other competing purposes?
- If the funds are not to be applied to a revenue-producing project, how will the benefit be monitored?
- If the purpose is a revenue-producing project, what are the expected cash flows and how do they match with projected out-flows of the project, including debt service? More broadly, from what sources is this debt going to be serviced? Will there be available public funds to meet these payments?
- Do the overall benefits justify the commitment of public funds to the overall cost of this debt?

All these costs, benefits and risks need to be clearly understood and recorded in the debt and cash-management tools of the debt managers.

## Managing Non-Financial Risks and Other Considerations

Prudent and sound debt management also requires that any debt raising should be executed after all relevant non-financial factors have been examined and considered, both for the specific transaction in question and within the overall debt management strategy.

Debt managers should ask themselves numerous questions to understand these issues more deeply. To the extent that there are uncertainties on any of these issues, it may be prudent to engage the services of professional legal and financial advisors.

**NATURE OF DEBT INSTRUMENT**

- Is the debt instrument familiar to the debt manager?
- How has this debt instrument served other comparable sovereign debtors?
- Would the instrument pose any extraordinary risks in the context of debt distress?
- If the debt instrument is not customary or usual in the market, what are the reasons or underlying circumstances for adopting it? If so, have specialist advisors been consulted? Have all risks been analysed/understood?

**NON-FINANCIAL CONTRACTUAL TERMS**

- What are the non-financial terms of the debt instrument?
- Are the events of default fair, appropriate and capable of being managed by the country? Do they contain unreasonable constraints on the ability of the country to exercise its sovereign powers?
- Are there any financial covenants or other triggers relating to financial performance? Do they represent a balance between the legitimate interests of the creditors and the sovereign nature of the debtor? Can they be (easily) monitored?
- Are there disclosure restrictions which are incompatible with the public nature of the debt, the obligations of the country to its multilateral and other creditors or its obligations under applicable laws and best practices?
- Are the governing law, jurisdiction and immunity provisions appropriate for the type of credit, prevailing market norms and the legitimate interests of the sovereign? Is the scope of any waiver of sovereign immunity properly qualified to exclude strategic state assets?
- Are the negative pledge restrictions compatible with the needs of the country and its SOEs to operate with some degree of autonomy and flexibility? And consistent with its other financing arrangements?
- Are confidentiality undertakings included in the financing which contradict the principle of transparency or the sovereign's contractual or legal obligations to other stakeholders? Could these provisions give rise to complications in debt distress situations?
- Is security required, whether effective, *de facto* or *de jure*? Can it be justified in the context of the overall financing? Is it consistent with the existing negative

pledge obligations of the sovereign? Will such security disturb, in a material way, the overall balance of risk and the legitimate expectations of its other creditors?

- Are the information covenants capable of being monitored and satisfied? Are they too onerous or unique in their preparation by reference to other information obligations of the country?
- Are the administrative provisions capable of being monitored and are they consistent with the relevant back-office teams of the debt manager?
- Is it clear how the terms of the debt instrument can be waived and/or amended? Are the consent requirements, thresholds and mechanics appropriate for the debt instrument, the types of creditors and market practice? Are the disenfranchisement provisions for state-affiliated entities appropriate and fair?
- Is the documentation more generally up-to-date and consistent with the market practice?
- Are there any other unusual or onerous terms? Or any terms which are currently subject to dispute, controversy or litigation elsewhere?

## FUTURE FLEXIBILITY IN DEBT LIABILITY MANAGEMENT OR DEBT DISTRESS

- Do the debt instruments include amendment provisions which enable the parties to agree on appropriate changes to contractual terms, whether desired for operational efficiency, optimisation of cash flow/debt management and/or to manage a distress scenario?
- Where there are multiple counterparties or where the consent requires the approval of bondholders, may decisions be taken with appropriately qualified majority consent (majority voting provisions or collective action clauses)? If so, what level of consent will be required for changes to core financial terms and to other categories of changes?
- Have appropriate mechanisms for coordinating amendment processes across different categories of financial instruments been considered (e.g., across a series of Eurobonds and Shari’ah-compliant instruments)?
- Will the identity of specific creditors matter in the process of reaching consent and adopting the agreed changes?
- Is the administrative process for approving changes clear, efficient and capable of certain outcomes in a reasonable timeframe?

## Understanding Your Creditors — Managing Your Investor Universe

Debt managers need to understand the objectives and interests of their creditors. The aim should be to ensure that these objectives and interests are aligned as much as possible with those of the country. It is also important to understand how these objectives and interests will determine creditors' preferences in both ordinary times and in times of distress. The questions raised seek to highlight the types of issues that debt managers should consider in order to understand these objectives and interests and their alignment.

- If the creditor is multilateral, what is the conditionality required and how easily can it be satisfied?
- Are the lenders under loan agreements entities committed to the country long term, either through their presence domestically or the nature of their funding?
- Are the lenders under loan agreements capable of transferring their interests directly or through sub-participations to creditors whom the country deems specifically or generically hostile to its interests? Should appropriate limits be set?
- Can this particular class of creditors be scaled up through similar debt instruments and if so what are the limits? Is the particular type of creditor one that might prevent the country from accessing other types of creditors?

## Two important considerations for debt managers

### EFFECTIVE AMENDMENTS

Debt managers must ensure that the terms of their debt instruments include clear and effective mechanisms which allow amendments to be made and waivers to be obtained. Debt instruments with large numbers of creditors should also have mechanisms that ensure that changes agreed upon by the large majority of creditors bind any dissenting minorities. Where possible, these provisions should also allow for aggregating creditors from several debt instruments to consider and approve, on an appropriate majority basis, the proposed amendment or waiver. For bonds, this means the inclusion of aggregated collective action clauses. As new types of instruments and investors are considered, their inclusion in the existing debt stock and investor universe must be considered very carefully.

For example, including Sukuks into the existing debt stock in practice requires consideration of whether Sukuks have collective action clauses binding minorities (a) within the same Sukuk issue, (b) within an aggregated set of other Sukuk issues, and (c) within an aggregated set of other Sukuk issues and/or conventional bonds.

The short answer to these three questions is that all these three things are possible. Practically implementing them is more challenging: (a) ICMA has not as yet published standard forms and guidance for Sukuk collective action clauses; (b) hitherto Sukuks have been issued principally under English law with New York law not having as yet been used for Sukuks; and (c) to aggregate conventional bonds with Sukuks, the sovereign issuer would have to amend the drafting of the collective action clauses in its existing conventional bonds. As with other complex legal matters, sovereign debt managers need to speak with appropriate legal advisors.

Debt managers should ask similar questions whenever they consider any new type of instrument and/or class of investor. The aim must include, in addition to appropriate cost and ongoing administration, the ability to effect changes endorsed by large creditor majorities quickly, efficiently and with minimal risk of disruption from dissenting creditors.

### ONEROUS TERMS — SECURITY

The granting of security over the assets of the sovereign in favour of only some creditors is something which debt managers should not do lightly. Security creates preferences and preferences undermine inter-creditor equity. Intercreditor equity is not just a concern for creditors. Fair treatment of creditors should be the aim of debt managers. Fair treatment sets a level playing field allowing more creditors to join in the future and allowing the debtor to ask for legitimate amendments and waivers when required. Security and other preferences given to specific creditors undermine trust and legitimise dissenting creditors wishing to pursue separate recovery strategies. When the debt needs to be restructured for reasons of prudent management or distress, such preferences, security or other unfair creditor treatment will undermine the achievement of needed consensus.

This is not to say that all security is inappropriate or disruptive. Project and trade finance require security as a matter of structure. Security over a particular asset may also provide necessary and cheap[er] finance. In these cases debt managers should proceed with caution, having regard to the above considerations and having taken advice from appropriate advisors.

# Debt Management throughout the Loan Cycle

The loan management cycle covers all the actions involved in loan management, starting from the time the loan was negotiated to the time it is fully paid off. It comprises all the steps taken to make and maintain a loan.

1. **Assessment of borrowing needs:** This is an important exercise that borrowing countries need to carry out carefully at an early stage. Generally, external financing is sought when domestic revenues are insufficient to provide economic and social development resources. These resources can be mobilised either in the form of grants which have no repayment costs or loans whose cost varies depending on the degree of concessionality. DMOs must carefully assess their country's capacity to absorb and use these resources productively. An appropriate type and source of credit needs to be identified with expected cash flow projections and the existing debt structure in mind so that the new borrowing will not excessively overburden the country.
2. **Negotiating and signing the debt obligations:** Negotiating the debt obligations is an important element of the debt cycle. The negotiating process can be complex depending on the type of financing the borrower wishes to raise. In addition to negotiating the terms and conditions of the loan, an understanding of the markets and of creditor practices is also important. Once details of the debt terms and conditions have been agreed upon, the debt contract will be signed by the authorised representative of the borrower and the lender(s).
3. **Fulfilment of conditions precedent for disbursement of loan monies:** Borrowing countries need to ensure that all conditions precedent are met so that disbursements can take place as scheduled. It is also important at the negotiation stage that countries ensure that these conditions are not too burdensome and can be met rapidly and without delay in disbursements. These conditions vary for each creditor and include administrative, legal, financial and economic policy conditions.
4. **Instrument effectiveness and drawdown:** Once all conditions precedent to effectiveness have been met, the loan becomes effective and can be disbursed. Disbursements can take place in one or two instalments as in the case of structural adjustment loans, or several instalments, as in the case of project loans. Usually, in these cases, the loan agreement will specify the minimum

number of days of notice required before any disbursement. Procedures for disbursement will also be specified in the agreement.

5. **Interest payments:** Once the money has been disbursed, interest accrues immediately and other payments agreed will be paid (e.g., management or commitment fees). The interest rate is charged on the Debt Outstanding and Disbursed (DOD) and is payable in arrears, in most cases, on a semi-annual basis. Interest can be charged at a floating rate or a fixed rate.
6. **Amortisation/principal repayments:** Repayments can be structured as bullet or amortising. Loans and bonds can be repaid through several equal/unequal instalments or as a lump sum at the end (bullet repayment), the latter being most common.
7. **Debt reporting:** To ensure that the government is accountable for its debt management operations to the creditors involved in specific financing, to parliament/congress and the country's citizens, frequent reports must be prepared (and often made publicly available) on debt and debt-related operations. Debt reports promote transparency in debt management operations and good governance through greater accountability.

## PROPER AUTHORISATION ACROSS THE LOAN CYCLE

The governance and approval process for new financing is often stipulated in a "debt management law" and must be followed to ensure any debt incurrence is appropriately authorised. It includes executive-level authorisation, legislative authorisation as well as other steps across the loan management cycle. For each of the stages in the debt management cycle, the necessary processes and approvals must be complied with. The debt negotiation and the agreement signing must be undertaken by authorised government officers. By way of illustration, in some countries, the debt agreement must be signed by the Minister of Finance with the advice of the Attorney General or the designated official of the Ministry of Justice. This authorisation process must be unambiguous to any third party.

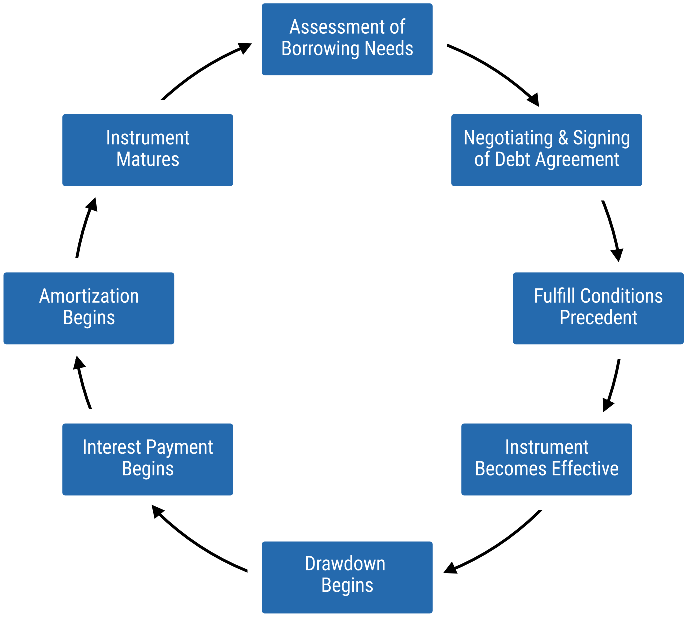



FIG. 6. The Debt Cycle

## Liability Management

Ongoing liability management is an integral part of a country's debt management strategy. The goal of liability management exercises can vary, such as the refinancing of costly loans at a cheaper rate or the reduction of short-term rollover risk. Below is a list of important mechanisms used by debt managers to conduct liability management exercises:

**Cash Tender Offers**: Through cash tender offers, the sovereign buys back its own debt before maturity at market prices. This can be used to reduce debt stock, manage the debt profile, or take advantage of favourable market conditions to reduce interest costs.

**Exchange Offers**: In an exchange offer, a sovereign issuer offers to swap existing debt for new securities. This can be used to extend maturities, reduce debt service costs, or alter the composition of the debt portfolio to better match the sovereign's debt management objectives.

**Bridge Financing**: This option involves temporary financing arrangements used to cover a sovereign's short-term liquidity needs until long-term financing can be secured. This strategy is often used to manage timing differences between expenditures and funding sources.

**Rollovers**: Rollovers involve the renewal of maturing debt obligations by issuing new debt. This can help in managing cash flows and refinancing needs without reducing the overall debt level. It is a common practice employed to manage short-term debt and liquidity.

**Buybacks**: Similar to tender offers but can be conducted more discreetly in the open market (subject to compliance with applicable securities legislation). Sovereigns repurchase their own debt securities, aiming to manage the debt burden and potentially improve the debt structure.

**Debt Swaps**: Including debt-for-debt swaps, where existing debt is exchanged for new debt with different terms, and debt-for-nature/health/education or debt-for-equity swaps, which involve the conversion of debt into investments in nature or social projects or equity stakes.

**Reprofiling**: Extending the maturities of debt instruments without changing the face value of the debt. This can help in alleviating short-term liquidity pressures without the need for a full debt restructuring.

**Consolidation Loans**: Taking out a new loan to pay off a variety of creditors. This can simplify the debt portfolio and potentially secure more favourable terms and interest rates.

## Building resilience and sustainability in the debt portfolio

Debt managers are increasingly looking to incorporate measures to increase resilience and sustainability within their debt portfolios. Climate change, environmental degradation, social issues and governance failures pose significant risks to financial stability and public welfare. There is an expanding toolkit of financing instruments or contractual modifications (e.g., climate resilient debt clauses) which can enable the sovereign to better prepare and respond to future shocks. Please refer to the Chapter *"Sovereign Bonds"*. In addition, by incorporating ESG factors into investment decisions, debt managers can identify and avoid investments that, for example, may become financially unsustainable due to future regulatory changes, reputational damage or physical and transitional risks associated with climate change.

Furthermore, aligning debt portfolios with sustainability goals is increasingly demanded by investors, regulators, civil society, local populations and other stakeholders. Investors are becoming more conscious of the impact their investments have on society and the environment and are seeking opportunities that generate positive outcomes alongside financial returns. Regulators are also pushing for greater transparency and disclosure regarding ESG risks and opportunities, which can influence investment decisions and regulatory compliance requirements.

By building resilience and sustainability into their debt portfolios, debt managers can not only enhance risk management practices but also contribute to the transition to a more sustainable and resilient global economy. This approach not only protects the interests of investors and stakeholders but also aligns with broader societal goals of promoting environmental stewardship, social equity and economic stability. For examples of measures that can be incorporated into the debt managers' strategy, please refer to the Chapter *"Sovereign Bonds"*.

# 14 Recording, Reporting and Maintaining Good Debt Data

Accurate and comprehensive debt data is a cornerstone of sound sovereign debt management. Borrowers must ensure that comprehensive records of general government debt (including off-budget entities and contingent liabilities) are maintained accurately and updated on a timely basis and that sovereign debt reports and data are regularly made available. Sound debt recording and reporting develop credibility, confidence and trust with policymakers, multilaterals, investors, financial markets and the general public.

While this chapter focuses on the day-to-day operations of the DMO, it is worth noting that reporting to particular stakeholders might be undertaken in a specific recurring timeframe and format. This includes reporting to domestic parliaments, multilateral institutions (e.g., the annual IMF Article IV consultation), credit rating agencies or investors.

## Coverage of Public Sector Debt

Best practice debt management requires centralised data collection and management on a consolidated basis that encompasses the entirety of the public sector. This will include the general government and all public corporations (which includes SOEs, state-owned banks and other entities) — as shown in the diagram below:

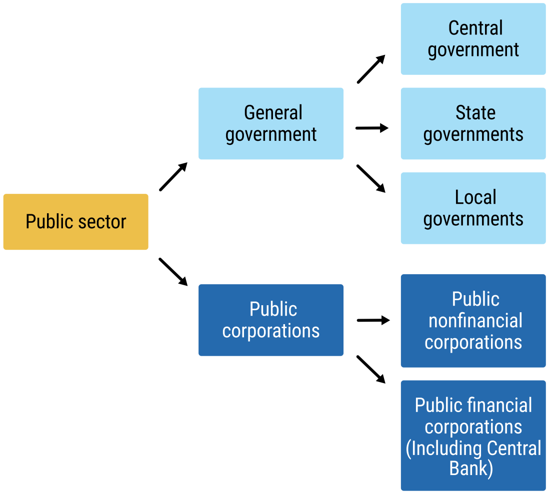



FIG. 7. Breakdown of Public Sector Debt per Category

All new indebtedness that is contracted, or any liability assumed that can have an impact on the financial position of the sovereign, should be included. All governmental bodies falling on the state "balance sheet" should be reporting on a regular basis, as well as whenever new indebtedness is contracted or any new liability is assumed.

## Maintaining Up-to-Date Records — the Practicalities

Experience shows that many sovereign governments lack accurate up-to-date records of their consolidated debt and liabilities. The practicalities of recording and maintaining up-to-date records are still operationally challenging to many country authorities due to the fragmentation of debt management responsibilities across several government ministries and agencies, lack of political ownership and support for debt management and high staff turnover in debt management units. Data on debt in several African countries suffers from substantial gaps, particularly on public guarantees and the debt owed to and by SOEs. This can result in a significant underestimation of public sector debt and liabilities while simultaneously undermining the integrity of the DSA.

Countries that are beginning the process of building capacity in sovereign debt management need to prioritise the development of accurate automated debt recording and reporting systems. These debt management information systems should include up-to-date records of all holders of existing debt and contingent liabilities of the bodies and agencies mentioned above. This depository should be in physical as well as electronic form.

The depository should not only include the original documentation evidencing the liability, but also any supplemental amendments, waiver requests and consents, extensions, roll-overs, notices and all other material legal communication to and from the underlying creditor(s). Bond issues will include communications with the listing agents/stock exchanges and international clearing systems. Complete records of all communications relating to financing should be maintained. Moreover, sound business recovery procedures should be in place to mitigate the risk that debt management activities and records might be severely disrupted by theft, fire, natural disasters, social unrest or acts of terrorism.

Given that government debt issuance is increasingly based on efficient and secure electronic book-entry systems, comprehensive business recovery procedures, including robust backup systems and controls, are essential to ensure the continuing operation of sovereign debt management, to maintain the integrity of ownership records and to provide full confidence to debt holders on the safety of their investments.

# 15 Debt Sustainability Analysis and Fiscal Risk Management

## Debt Sustainability

Debt Sustainability Analysis (DSA) is an essential tool in public finance and debt management, especially for countries navigating the challenges of balancing economic development with manageable debt levels. DSAs are utilised by various stakeholders, including governments, international financial institutions (IFIs) like the IMF and the World Bank, as well as private sector creditors and investors. The purpose of the DSA is to assess the ability of a country to meet its current and projected debt service obligations.

### KEY COMPONENTS OF DEBT SUSTAINABILITY ANALYSIS

- **Debt Projections and Scenarios:** DSAs involve projecting the future path of a country's debt stock under different scenarios, including baseline projections based on current policies and alternative scenarios that consider shocks or policy changes. Contingent liabilities are taken into account in the preparation of DSAs.
- **Debt Indicators:** Various debt indicators are used to assess sustainability, including the debt-to-GDP ratio, debt service-to-revenue ratio and the external debt-to-exports ratio. These indicators provide a measure of the debt and debt service burden relative to the size of the economy and the country's ability to generate revenue and foreign exchange earnings.
- **Thresholds and Benchmarks:** DSAs compare these indicators against certain thresholds or benchmarks that are considered sustainable. These thresholds may

vary depending on the country's specific circumstances, including its level of development, access to financial markets and vulnerability to shocks.

- **Policy Analysis:** The analysis also involves assessing the impact of current and proposed fiscal and economic policies on debt sustainability. This includes examining fiscal adjustments, structural reforms and investment plans to determine their implications for debt dynamics.

### IMPORTANCE AND USES OF DEBT SUSTAINABILITY ANALYSIS

- **Informing Policy Decisions:** DSAs help governments make informed decisions regarding borrowing and the incurrence of guarantees and other contingent liabilities.
- **Guiding International Support:** DSAs are used by IFIs to determine the appropriate level and type of financial support for countries, including loans, grants and debt relief.
- **Information to Investors and Market Confidence:** For investors and creditors, DSAs provide valuable information on a country's creditworthiness and the risks associated with lending. A positive assessment can enhance a country's ability to access international capital markets and improve the terms of borrowing.
- **Preventing Crises:** Perhaps most importantly, DSAs play a critical role in identifying risks and helping sovereigns avoid potential debt crises. By detecting unsustainable debt dynamics early, countries can take preemptive action to avoid debt distress or restructuring.

## Management of Fiscal Risk

Fiscal risk refers to the uncertainty associated with forecasting future government revenues and expenditures, which can lead to deviations from expected fiscal outcomes. These risks can stem from a wide range of sources including macroeconomic volatility, financial sector vulnerabilities, natural disasters and contingent liabilities. The materialisation of fiscal risks can lead to significant fiscal and economic instability, necessitating careful management and mitigation strategies.

### SOURCES OF FISCAL RISK

**Macroeconomic Risks:** Fluctuations in economic growth, exchange rates and commodity prices can impact government revenues and expenditures.

**Tail Risk Events/Pandemics, Natural Disasters and Climate Change:** These can cause abrupt and significant increases in government spending on relief and reconstruction efforts.

**Contingent Liabilities:** These are potential obligations that may result in future government spending depending on the occurrence of certain events. For example, crises in the banking or financial sector can lead to significant fiscal costs, especially if the government needs to intervene to stabilise the system.

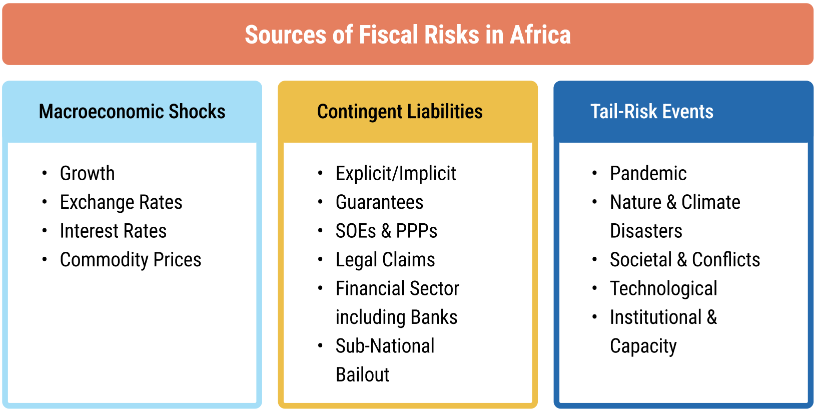



FIG. 8. Fiscal Risk Assessment

Effective management of fiscal risks requires a comprehensive approach that includes identification, analysis, disclosure and mitigation of risks. A Fiscal Risk Management assessment often entails:

- **Risk Identification and Assessment:** Systematic identification and assessment of fiscal risks, including both explicit and implicit contingent liabilities. This involves cataloguing potential risks and evaluating their likelihood and potential fiscal impact.
- **Macro-fiscal Stress Testing:** Assessing the resilience of public finances to adverse macroeconomic scenarios. This involves using stress tests to simulate the impact of various economic shocks on government finances.
- **Contingent Liability Management:** Establishing frameworks for managing contingent liabilities, such as setting caps on guarantees, charging appropriate

fees for guarantees and creating contingency funds.

- **Medium-term Fiscal Frameworks:** Developing fiscal frameworks that incorporate risks and uncertainties over the medium term, including the establishment of fiscal buffers in good times to be used in bad times.
- **Fiscal Risk Statements:** Preparing and publishing fiscal risk statements as part of the budget process. These statements provide a comprehensive overview of fiscal risks, their potential fiscal impact and mitigation measures.
- **Legal and Institutional Frameworks:** Establishing strong legal and institutional frameworks that support fiscal risk management, including clear mandates for risk assessment and monitoring.

# 16 Enhancing Sovereign Debt Transparency and Accountability

Sovereign debt transparency refers to the dissemination of timely, comprehensive, accurate, accessible and intelligible debt data, policies and operations. It requires the public disclosure of materially important aspects of debt management operations, particularly the outstanding stock and composition of its debt liabilities and financial assets and, where they exist, contingent liabilities. It should, however, be emphasised that sovereign debt transparency goes beyond sovereign debt reporting. All stakeholders have a role to play in promoting debt transparency as outlined below:

## 1. Role of Government

The primary responsibility of ensuring debt transparency lies with the government of the borrowing country. The government needs to ensure that the legal framework and institutional arrangements enforce transparency in the contracting, management and reporting of sovereign debt and contingent liabilities.

## 2. Role of Creditors

Creditors have the responsibility of ensuring transparency in lending and investment practices. In this regard, the Institute of International Finance has called on all creditors, especially private lenders, to voluntarily disclose financial transactions to enhance sovereign debt transparency. The Institute of International Finance has published a set of principles available at the site and a repository for posting information about the transactions which is hosted by the OECD.

## 3. Role of Demand Side

The demand side of governance, including the civil society, media, parliament and SAIs, is important in ensuring sound debt management. Citizens and civil society organisations and the media have the responsibility to demand accountability and transparency from governments regarding sovereign debt and wider public financial management.

The parliament in most jurisdictions, especially where they have the power of the purse, has the responsibility for authorising and oversight of sovereign debts. This function must be exercised based on adequate and timely information being made available to the parliament across the loan management cycle by the executive.

The SAIs should undertake statutory, risk-based and performance audits of the country's debt activities in a timely manner. These provide effective feedback to the executive, parliament and the public on the performance, integrity and compliance of the government's debt-raising and management activities with extant legislations and procedures.

## 4. Role of Credit Rating Agencies

Credit rating agencies provide information about the borrowers that helps investors and lenders make decisions on their level of exposure to a country or borrower. Their review and opinions are highly valued by the stakeholders in the debt market and directly affect creditor behaviour. The factors they consider in their assessment include the country's macroeconomic performance, IMF DSAs, quality of the debt management office reporting and domestic sovereign debt repayment. Credit ratings are not only beneficial to the lenders, but they also benefit the borrowing country as they provide more transparency over debt management activities.

## Key attributes to ensure transparency in debt reporting:

**Comprehensiveness:** Sovereign debt should include all government debt types, including contingent liabilities outstanding as of the reporting period, in accordance with the best of international practice.

**Accuracy:** Debt numbers should be reported in full and be free from errors. The debt recording function must be strengthened and harmonised and debt data must be regularly validated and reconciled with creditors to ensure accurate debt records and reports. Additionally, the debt valuation method should be clearly outlined and adhered to.

**Timeliness:** Reports must be well sequenced; the DMO must ensure that reporting frequency is established and reports are published on time. This will reduce speculations around delays in debt publications and potential market disruption.

**Accessibility:** Every stakeholder group should be able to access the published data with ease and data must be targeted to address the needs and understanding of specific stakeholder groups.

Source: Adapted from Commonwealth Secretariat 2023: *A Handbook for Sovereign Debt Transparency*.

# 17 Development and Maintenance of Efficient Domestic Credit and Capital Markets

Historically, African countries have funded themselves in foreign currency debt as a result of the limited depth of the domestic financial markets. This is a cause for concern since high levels of foreign-currency debt exposure increase a sovereign's vulnerability to refinancing, exchange rate risk and macroeconomic shocks.

Strengthening domestic debt markets can help mitigate these risks and provide a stable and sustainable source of local currency financing. Domestic markets also have an important role to play in mobilising private capital to finance domestic development. At the same time, well-functioning domestic bond markets allow governments to manage macroeconomic and fiscal risks and provide pricing benchmarks for local companies.

In many countries, decisions by debt managers have been important catalysts in developing the overall structure of the domestic credit and capital markets. These decisions include which types of instruments to issue, the most appropriate issuance strategy and market infrastructure for supporting these instruments — all of which are critically important to the development of domestic capital markets. In particular, domestic financial institutions benefit from having available sovereign debt instruments in which to invest and that can provide benchmarks for the pricing of other market borrowers (including corporates). This, in turn, broadens the domestic credit markets, making domestic credit available to enterprises and individuals.

Overall, a well-developed domestic credit and capital market can facilitate economic development and make the economy more resilient to external shocks.

The starting point for the development of the domestic debt market may be to undertake an assessment and benchmarking of the existing domestic debt market to determine its strengths, weaknesses and gaps.

## Prerequisites for Domestic Debt Development

- **Legal and Regulatory Framework:** There is a need for a well-defined legal and regulatory framework covering the government's domestic debt operations and overall public financial management. This must be harmonised with securities, banking and other pertinent laws and regulations. In addition, a robust tax system and regulatory infrastructure should be in place.
- **Macroeconomic Stability:** The development of the domestic debt market subsists on sound macroeconomic policies by the government. There is, therefore, the need to harmonise both fiscal and monetary policies to ensure macroeconomic stability.
- **Market Infrastructure:** There is a need for a market infrastructure that supports trading and ensures efficiency in government securities. It is key for the government to invest in state-of-the-art auction systems, Central Securities Depository, payment and clearance systems, etc.
- **Money Market Development:** Developing an active money market is key to the development of the domestic debt market. The money market provides liquidity and supports financial institutions to cover their short-term liquidity needs.
- **Development of Yield Curve:** It is important for the government to develop a yield curve for government securities by introducing a range of short-term, medium-term and long-term instruments in line with investor preferences.
- **Diversified Investor Base:** The dominance of the banking sector in the domestic debt market has been shown to undermine financial market stability and economic growth. It is, therefore, important for the government to diversify the investor base to include more institutional investors. There is also the need for continuous market engagements through a well-planned investor relations programme to provide needed market information to investors.

- **Institutional Capacity:** There is a need for strong institutions both on the issuance and regulatory side of the market to ensure that operations are fair and transparent. As the issuer, the government needs to provide adequate resources to debt management offices to ensure that they are well-equipped in their issuance, management and reporting functions.
- **Transparency:** The domestic market thrives on information, and there is a need for the government to ensure that information is made available to the market in a timely and transparent manner to foster investor confidence.

## Challenges to Domestic Debt Market Development in Africa

The benefits of the domestic debt market notwithstanding, recent developments in some African debt markets post the COVID-19 pandemic have heightened concerns about the impact of government domestic debt operations on financial stability in the domestic market. It is, therefore, imperative for countries with nascent debt markets to be strategic in their policies and approach to developing these markets. Some of the peculiar challenges that African countries face are discussed below:

### SMALL ECONOMIES

Countries with relatively small economies have found it particularly challenging to develop their domestic debt markets. These countries tend to lack effective financial markets, infrastructure and skilled capacity to operate capital markets. In these contexts, the development of regional capital or debt markets can open up opportunities for all countries to access financing on fair terms.

### GOVERNMENT DOMINANCE

Government dominance in the domestic debt market can crowd out private sector participation and limit the extent to which the domestic debt market could develop. The expectation for market development is for the government to provide the necessary benchmarks to encourage other private sector participation (corporate issuers). However, there is a tendency for African governments to become the only significant issuers in the domestic marketplace, so stifling other participants. For instance, if government debt offers more attractive returns than the private sector entities can afford, this can exclude private sector borrowers and reduce their participation in the market.

## BANKING SECTOR

The banking sector is critical to the development of the domestic debt market. In some countries, the banking sector is not playing this role well enough either because they are risk-averse or the macroeconomic policy environment does not support effective participation of the banking sector. The monetary authorities and the debt management agencies should design strategies that encourage the banking sector's participation in the domestic debt market.

## FRAGILITY

Fragility poses a challenge to the development of capital markets. Fragile environments are characterised by conflicts, insecurity, economic instability and lack of investor interest.

### Other challenges which are impediments to Domestic Debt Market Development in Africa include:

- Absence of savings culture; low-income levels, inflation, poverty, uncertainty.
- Paucity of institutional investors and lack of interest from international investors.
- Absence of sound market infrastructure; complex and inconsistent legal, regulatory and tax environment, uncertainty over enforcement.
- Economic instability (high fiscal deficits, hyperinflation, deteriorating exchange rate); the general absence of sound fiscal and monetary policies.
- Uncertain political environment; lack of stable government, social tension.
- Issuance and trading costs; regulatory, professional and other costs.
- Low return on investment; the opportunity cost of capital.

# 18 Swaps

Interest rate swaps and cross-currency swaps are often used by sovereigns to hedge interest rate and foreign exchange risk. They are examples of over-the-counter (OTC) derivatives transactions.

## Interest Rate Swaps

A typical interest rate swap involves one party agreeing to pay a floating rate of interest on a notional principal amount, in exchange for a fixed rate of interest on the same notional principal amount. Principal amounts are not exchanged. The interest rate payments will be made on scheduled payment dates during the term of the interest rate swap transaction.

A sovereign which has borrowed money (for example, USD 100 million) at a floating rate of interest (for example, on a SOFR basis) payable semi-annually, might wish to hedge both the risk of SOFR increasing and the risk that its own currency depreciates against the US dollar. It could hedge that risk by entering into an interest-rate swap with a bank. The bank would agree to pay the sovereign SOFR on a notional principal amount of USD 100 million on the same interest payment dates as the loan and the sovereign would agree to pay the bank a fixed rate on the same notional principal amount and the same payment dates.

The effect for the sovereign is that it pays a fixed rate under the swap and receives the floating rate that it needs to pay to its lender.

## Cross-Currency Swaps

A cross-currency swap involves one party agreeing to pay a rate of interest (which could be fixed or floating) on a notional principal amount denominated in one currency, in exchange for a different rate of interest (which could be fixed or floating) on a notional principal amount denominated in another currency. Unlike interest rate swaps, principal amounts are exchanged at the beginning and the end of a cross-currency swap transaction. The interest rate payments will be made on scheduled payment dates during the term of the transaction.

A sovereign which has borrowed money (for example, USD 100 million) at a floating rate of interest (for example, on a SOFR basis) payable semi-annually, might wish to hedge both the risk of SOFR increasing and the risk that its own currency depreciates against the US dollar. It could do so by entering into a cross-currency swap with a bank. At the start of the transaction, the bank would agree to pay the sovereign the local currency equivalent of USD 100 million and the sovereign would pay USD 100 million (the amount that it borrowed) to the bank. During the term of the transaction, the bank will pay the sovereign SOFR on a notional principal amount of USD 100 million on the same interest payment dates as the loan and the sovereign will pay the bank a fixed rate on a notional principal amount equal to the local currency equivalent of USD 100 million on the same payment dates. At maturity of the transaction, the bank will pay the sovereign USD 100 million (allowing the bank to repay its USD debt) and the sovereign will pay the bank the same amount in local currency that it received at the start of the transaction.

The effect for the sovereign is that it has hedged both interest rate and foreign exchange risk associated with the USD loan.

## Commodity Price Swap

In addition to hedging interest rate and currency risk through a swap, a sovereign might also wish to hedge commodity price risk (the risk that the prices for commodities exported will drop). It could do so by entering into a commodity price swap under which it agrees to pay an amount to its swap counterparty if the commodity price exceeds an agreed-upon level and to receive payments if the commodity price is below that level.

## Swap Agreements

Interest rate swaps and cross-currency swaps are usually entered into OTC: they are privately negotiated and not subject to the standardisation that would be required for contracts listed on an exchange, although swaps are sometimes available on trading platforms.

Although executed bilaterally between two contracting parties, certain types of OTC derivatives — those that are relatively standard and which have not been customised — may be cleared through clearinghouses. Non-standard and customised OTC derivatives remain bilateral transactions throughout their term.

The contracts required to support OTC derivatives are complex. They are often based on standard forms, including a master agreement, published by the International Swaps and Derivatives Association, Inc. (ISDA) but they can be heavily negotiated.

Although derivatives are designed to reduce the risk for one party (for example, interest rate risk for the sovereign) by shifting that risk to another party, one of the consequences for a party entering into a derivative is that it takes on credit risk; the risk that its counterparty fails to perform on what would otherwise be a valuable transaction for that party. There are several techniques for mitigating and reducing this risk.

One of the most important techniques is "netting". ISDA's master agreement contains close-out netting provisions — provisions in the agreement that allow one party to terminate outstanding transactions if the other party defaults and, having terminated, to calculate a single net amount payable between the parties reflecting the costs (or gains) of the non-defaulting party in replacing the terminated transactions.

Another common technique for reducing credit risk is collateralisation. It is common for parties to OTC derivatives to exchange margins in the form of cash and/or securities.

# Managing Contingent Liabilities

## *Key Points*

*Contingent liabilities are obligations that may or may not become actual liabilities, depending on whether particular events occur in the future. Therefore, these are not debt that needs to be serviced.*

*Proper frameworks for recording, monitoring and, where appropriate, adequate provisioning of contingent liabilities, are key to addressing future contingencies and mitigating fiscal risks.*

*Contingent liabilities can be explicit and/or implicit and arise from a range of circumstances.*

A specific chapter has been dedicated to contingent liabilities due to their importance and potential negative impacts on the sovereign's debt sustainability.

# 19 What is a Contingent Liability?

Contingent liabilities are obligations that may or may not become actual liabilities, depending on whether particular events occur in the future. Until they materialise (or are realised), contingent liabilities do not require to be serviced and are not included in the definition of debt under most public accounting and statistical standards. However, just because they do not make an immediate demand on the sovereign's cash flow, they should not be overlooked by government officials. As they affect a country's financial outlook, they will be included in a DSA.

Recent history on the Continent shows that contingent liabilities are a significant source of fiscal risk. Debt managers should ensure that the impact of risks associated with contingent liabilities on the government's financial position is taken into consideration when conducting the debt sustainability analysis. Contingent liabilities produce an "iceberg" illusion (as illustrated below), in that one can see certain liabilities but not all of them, due to their contingent nature. This type of liability is increasingly recognised as important. In several cases, failure to disclose and prepare for such risks has led to large increases in sovereign debt and triggered fiscal crises.

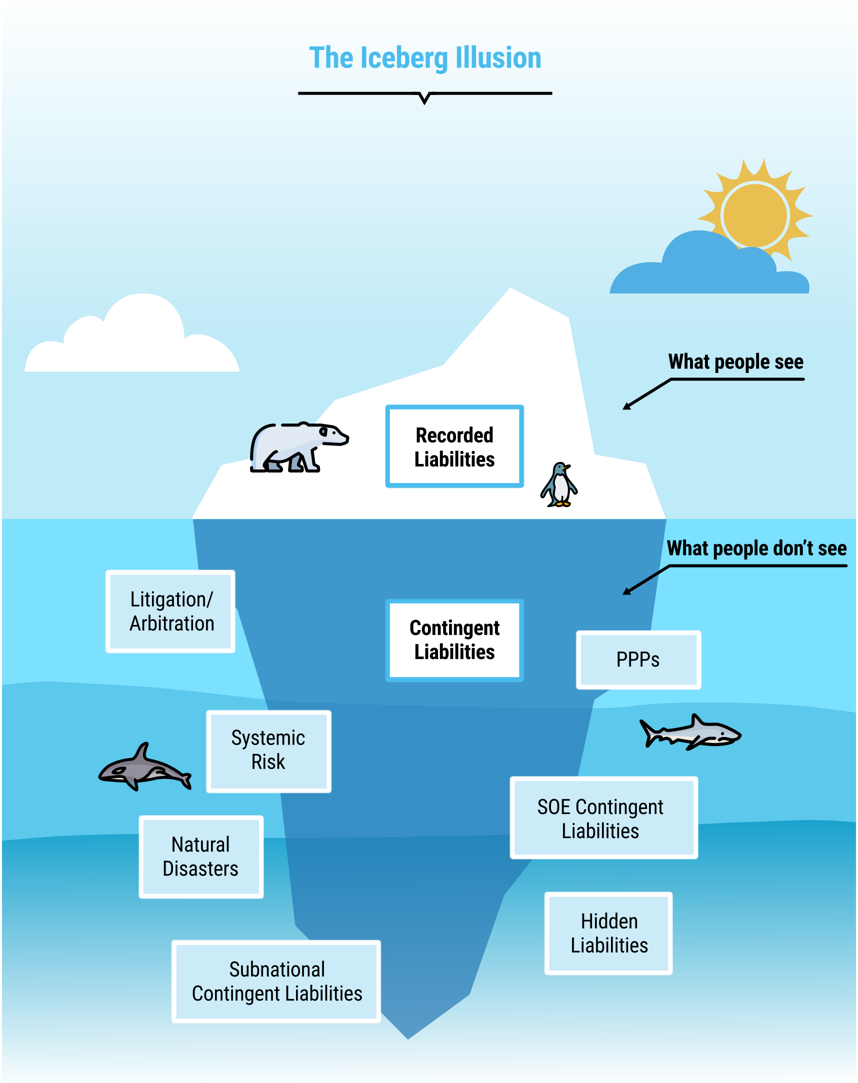



FIG. 9. Contingent Liabilities "The Iceberg Illusion"

# Types of Contingent Liabilities

The following types of contingent liabilities and their consequences are considered in this chapter:

1. Explicit contingent liabilities arising from express contractual obligations such as credit enhancements and other credit support instruments. These include guarantees, on-lending arrangements, counter-guarantees, indemnities and price-support mechanisms.
2. Implicit contingent liabilities arising from the sovereign's public service and general political economy obligations, such as supporting future pensions and health and education services, bank bailout, subnational debt, and SOE debt.

TABLE 8. Taxonomy of Contingent Liabilities

| | Direct liabilities | Contingent liabilities |
|---|---|---|
| Explicit Liabilities (Legal obligation, no choice) | • Foreign and domestic sovereign debt.<br>• Budget expenditures — both in the current fiscal year and those legally binding over the long term (civil servant salaries and pensions). | • Guarantees for borrowing and obligations of subnational governments and SOEs.<br>• Guarantees for trade and exchange rate risks.<br>• Guarantees for private investments (PPPs).<br>• State insurance schemes (deposit insurance, private pension funds, crop insurance, flood insurance, war-risk insurance).<br>• Unexpected compensation in legal cases related to disparate claims. |
| Implicit Liabilities (Expectations, political decision) | • Future public pensions if not required by law.<br>• Social security schemes if not required by law.<br>• Future health care financing if not required by law.<br>• Future recurrent cost of public investments. | • Defaults of subnational governments and SOEs on non-guaranteed debt and other obligations.<br>• Liability clean-up in entities being privatised.<br>• Bank failures (support beyond state insurance).<br>• Failures of nonguaranteed pension funds, or other social security funds.<br>• Environmental recovery, natural disaster relief. |

## EXPLICIT CONTINGENT LIABILITIES

Explicit contingent liabilities are express legal or contractual commitments of the Central Government. They take the form of government guarantees, counter-guarantees, indemnities and other price support mechanisms. These are sometimes referred to generically as "credit enhancement" or "credit support".

## GUARANTEES

A guarantee is an undertaking by a person (the "guarantor") to answer for the payment or performance of another person's debt or obligation (the "primary obligor") in the event of non-payment or non-performance of the obligation by the primary obligor. A government guarantee is a common and recognised form of credit support which has the advantage of not directly impacting the government's liquidity. As with all credit enhancement instruments, great care should be taken when drafting them. In particular, sovereign debt managers should be clear on (a) the extent of the guaranteed obligations and (b) the trigger which entitles the beneficiary of the guarantee to demand payment or other performance under the guarantee.

### Direct Sovereign Guarantees

African states often issue direct **sovereign guarantees** in the context of critical government-supported projects that are expected to produce long-term economic benefits.

Direct sovereign guarantees can take various forms and may appear under different names depending on the nature of the overall arrangements or the market conventions within which they operate. They may be documented as standalone separate documents or included in other documents (e.g., the debt contract between the creditor and the primary obligor) which will cover many other matters besides the guarantee.

For example, in the case of large infrastructure projects, guarantee provisions may be included either in standalone documents labelled 'sovereign guarantee' or 'government guarantee' or embedded in one of the many documents of such a project, such as implementation agreements, concession agreements and government support agreements/letters of comfort. They may also take the form of put-and-call option agreements.

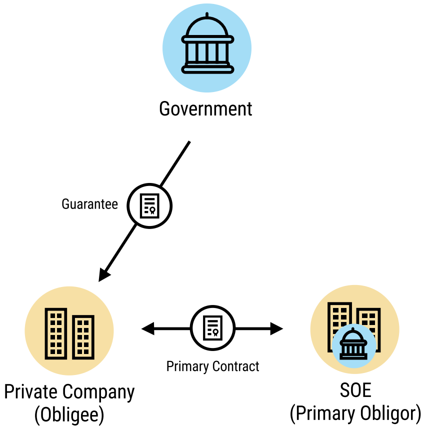



FIG. 10. Direct Sovereign Guarantees

The scope of guarantees varies enormously. They can range from a simple guarantee limited to covering a termination payment to the creditor to a guarantee of every single financial payment, or other loss, cost or expense of the creditor. Nevertheless, the main purpose of a sovereign guarantee is always the same: to enhance or support the creditworthiness of the primary obligor.

## Important note on Sovereign Guarantees

A sovereign should carefully assess whether to issue a guarantee, as such an instrument may impact the sustainability of its debt. As much as possible, sovereigns should resist issuing guarantees for projects or transactions in sectors that are not critical to the growth of their economy, especially if the primary obligor is a private entity.

However, there are important factors to consider beyond the nature of the risk the guarantee presents. The assessment must also consider the SOE's capitalisation when the guarantee is intended to support a state-owned enterprise. Accounting standards and best practices typically recommend consolidating the SOE's balance sheet into the country's fiscal accounts when the SOE is undercapitalised. Furthermore, even if the sovereign does not consolidate accounts with its SOE, DSAs conducted by the IMF are likely to do so. Therefore, issuing a guarantee for the benefit of an SOE may, in certain circumstances, have a very limited impact on the debt sustainability of the sovereign since the *primary* obligations would in any case be considered to sit on its balance sheet.

Sovereign guarantees help the sovereign manage the risks associated with contingent liabilities, especially when related to critical sectors such as infrastructure or energy. These guarantees may help specify the scope of the government's payment obligations, clarify the events that will trigger them, impose notification obligations and provide for periods to address any defaults. Guarantees can therefore produce the tangible benefit of delineating the risk profile of contingent liabilities and they ensure that the government is fully aware of the liabilities taken on by its SOE.

Another factor a sovereign should assess when issuing a guarantee is whether the underlying transaction will displace other contingent liabilities such as systemic liabilities. For example, if an energy project is expected to reduce demand on foreign exchange, a sovereign guarantee enabling such a project may improve the overall contingent liability landscape rather than worsening it. A careful analysis is therefore needed to provide a more accurate understanding of the instrument's impact on debt sustainability, and sovereigns should develop a sound framework for approving sovereign guarantees.

### Indirect or Counter-Guarantees

An indirect or counter-guarantee arises when the government agrees to guarantee the obligations of another guarantor as opposed to the obligations of the primary obligor.

There are at least four parties involved when a counter-guarantee is issued by a government: the government itself as the counter-guarantor, the primary guarantor, the primary obligor and the creditor. The primary guarantor is typically a financial institution with a high credit rating. The counter-guarantee adds another level of credit enhancement for the underlying transaction, as the creditworthiness of the counter-guarantor will also be considered by the creditor (and any other interested parties such as rating agencies) in their credit analysis of the transaction.

For example, a financial institution (the primary guarantor) might require a government counter-guarantee to agree to issue a letter of credit in favour of a private company (the creditor). For the government, granting a counter-guarantee to the primary guarantor has an equivalent credit risk to granting a guarantee directly in favour of the creditor. The creditor may only be able or prepared to enter into the primary contract if the credit support comes from the financial institution/primary guarantor.

Another example of using a counter-guarantee is in the context of a **partial risk guarantee** (PRG). The PRG is an instrument issued by a multilateral bank (the primary guarantor) to a private entity (the creditor) to guarantee a specific number of payments under an infrastructure or other large-scale project. In turn, the multilateral bank (the primary guarantor) will require the government (as counter-guarantor) to counter-guarantee the obligations of the multilateral bank under the PRG. If the multilateral bank must pay under the PRG, it will request reimbursement from the government under the counter-guarantee. As a result, the government will have a liability contingent on the risk that the multilateral bank makes a payment under the PRG.

It is important to note that because of the counter-guarantee, the PRG structure will create a contingent liability similar to the one created under a direct guarantee by the government in favour of the creditor. This is because the risk is ultimately the same, i.e., the default of the primary obligor (typically an SOE) to the creditor under the contract guaranteed by the PRG. For the government, the advantage of the PRG lies in the government's ability to obtain better financing terms for the primary obligor (its own SOE) as the risk for the creditor is reduced through the mediation of the multilateral bank as primary guarantor.

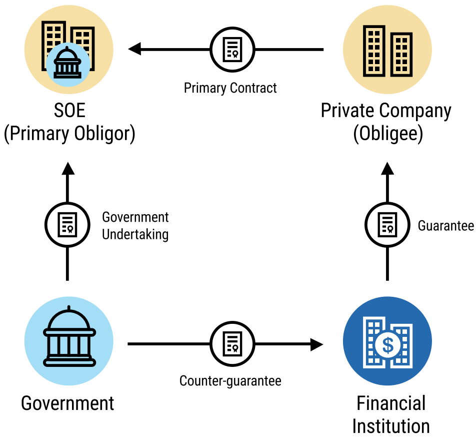



FIG. 11. Counter-Guarantee Structure

## EXPORT CREDIT COUNTER-GUARANTEED BY THE SOVEREIGN

While finance through official ECAs is crucial for some products (such as aircraft), government intervention in the export credit business is mainly to insure or guarantee private export credit. In all of these cases, the guarantee (or other support) given by the ECAs will be counter-guaranteed by the sovereign, and, to the extent that the ECA guarantee is called, the underlying debt will become a government-to-government debt. Debt managers should therefore monitor the sovereign's exposure through such ECA counter-guarantees, noting whether members of the Paris Club provide the ECA cover or not.

## INDEMNITIES

Government support can also form an agreement to indemnify a party in the event of a loss. Such indemnities are broader in their scope as compensation mechanisms but have ultimately similar effects to comprehensive guarantees or counter-guarantees.

For example, insurance for political risk from a multilateral bank (e.g., MIGA) issued to ease the fundraising efforts for a specific infrastructure project will typically require the government to agree to indemnify that multilateral bank if a claim is made under the insurance policy. For this purpose, a liability contingent on the risk of a claim under the political risk insurance will be created by the indemnity and should be recorded as a contingent liability.

The key difference between indemnities and guarantees is that under a guarantee claim, the guarantor will be liable only for a well-founded claim. An indemnity claim will not consider whether or not the indemnified party *should have* suffered a loss, but only if it has, in fact, suffered a loss. It is technically easier to get compensated under an indemnity than under a guarantee.

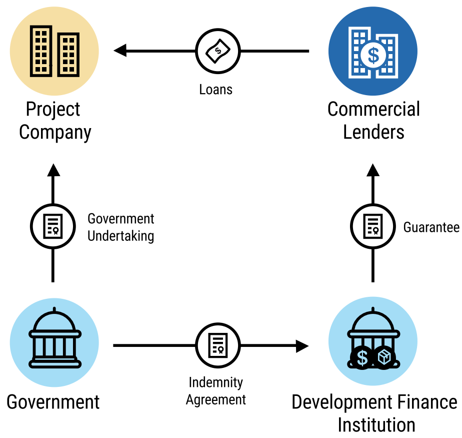



FIG. 12. Indemnification Structure

## PRICE SUPPORT UNDERTAKINGS

Price support undertakings are agreements to intervene if the revenue anticipated by the creditor proves to be less than a pre-agreed minimum "floor" amount (the "minimum expected revenue"). The revenue fluctuation may be linked to commodity prices, currency exchange rates or other relevant factors. As a result, the compensation mechanism may vary significantly from one agreement to another, depending on the nature of the risk guaranteed by the government. However, once the creditor claims a shortfall, the government will pay the difference between the minimum expected revenue and the actual revenue.

Price support undertakings therefore serve a function similar to a guarantee. The contingent liabilities they create should be analysed and assessed with the same care and rigour.

## KEY CONSIDERATIONS FOR EXPLICIT CONTINGENT LIABILITIES

Credit enhancement instruments giving rise to explicit contingent liabilities may vary greatly in their scope. They can range from a full guarantee of the primary obligor's obligations under the primary contract, or they may be limited to specific types of losses, size of amounts or circumstances in which they can be called.

Credit enhancement instruments may also cover risks which are not included in the primary contract but by nature, are considered to be under the government's control (e.g., political risk). The terms of a credit enhancement instrument will depend on several factors including the creditworthiness of the primary obligor, the nature of the risks covered and whether other credit enhancement instruments are in place.

The government must clearly understand the nature of the primary obligor's obligation to the creditor. It should always analyse both the terms and conditions of the credit enhancement instrument it is being asked to provide and the primary contract as well as the implications for the country's fiscal condition. Failure to do both may result in a serious miscalculation of the nature and scope of the contingent liability assumed. To mitigate credit risks and ensure the primary obligor (such as SOE) performs its obligation, the government should adopt a clear policy on, e.g., the conditions for issuing, approving and monitoring guarantees and charging a guarantee fee.

The government should require the primary obligor to promptly notify it of any breach/default (however minor) in respect of the primary contract. The government's credit enhancement instruments should not be capable of being extended to cover liabilities arising under the primary contract if such contract is amended or its terms waived without the government's prior consent. The government should retain the right to cure any breach/default before such breach/default leads to the termination of the primary contract as the cost of the cure may be substantially less than any payment due under the credit enhancement instrument.

## IMPLICIT CONTINGENT LIABILITIES

An implicit contingent liability is a contingent liability that does not emanate from express legal documentation (contract, legislation or otherwise). Once such liability materialises, the sovereign will choose to recognise it because of the nature of the primary obligor or the social impact which may result from defaulting on such liability. In some cases, the liability will be recognised by the state because it threatens the viability of a key actor such as an electricity utility or because of the social pressures that would ensue following the failure of such an entity (e.g., a public pension fund scheme).

The implicit nature of these liabilities makes them difficult to account for. Establishing an exhaustive list of actors that produce implicit contingent liabilities is also challenging.

## LIABILITIES OF SUBNATIONAL OR POLITICAL SUBDIVISIONS

### Federal States, Regional Governments, Provinces, Municipalities

Some sovereigns may have a decentralised political and administrative system consisting of different tiers of government (federal and unitary governments, subnationals, local authorities, and intergovernmental fiscal relations). In addition, large urban or systemic trade areas may enjoy the benefits of municipal or other forms of local government.

In each case, these subnational entities will have their own budgets and independently manage them. Thus prudent debt management requires that their liabilities, revenues and other assets be monitored, as, in extraordinary times, any of these subnationals may find themselves in financial difficulties. In such cases, the sovereign may need to extend unanticipated assistance to one or more of these subnationals, possibly even assuming their outstanding debt liabilities. This means a further liability to be accounted for in the sovereign's overall debt management strategy.

## "SYSTEMIC" RISKS

However sound the overall management of an economy is, a sovereign may still find itself challenged in extraordinary times by systemic risks. These systemic economic risks raise a number of challenges. Mitigating these risks may require the sovereign to support sectors of its economy even though it has no contractual obligation to do so (unlike in the case of its debt securities, loan agreements and credit enhancement instruments). The systemic nature of a liability principally refers to the importance of the government's intervention to prevent the insolvency of one or more entities from spreading and evolving into a deeper economic crisis.

Since the economic strength of a sovereign derives from the economic activity within its market, the sovereign is effectively dependent upon key market sectors to implement its economic policy and debt management strategy. For example, the financial collapse of the domestic banking sector, over-indebtedness of the corporate sector or technical disruption of the power sector would cause a drop in economic activity and, by extension, a weakening of sovereign wealth and growth. Each sovereign's banking, corporate and energy systems may differ, but, if any of them faces insolvency, the sovereign needs to be prepared to step in and take action, including bailouts in extreme circumstances. If action is not taken, the entire system, or at the very least, those parts without which the system cannot survive, risks collapsing.

**ARBITRATION AND LITIGATION CLAIMS**

A sovereign is likely to have entered into bilateral investment treaties (BITs) with other sovereign countries. Such treaties afford a host of protections to private investors resident in these countries and investing in the host country. These protections cover most types of foreign direct investment and even extend, in many cases, to investments in sovereign debt securities. BITs usually allow such investors to take to arbitration any claims against the sovereign for not affording them the proper level of protection provided under the treaty.

If the arbitration results in an award for a compensation payment against the sovereign, it will be important for debt managers to consider the need to satisfy that award. Debt managers will have to consider whether non-payment of the award, or even a simple delay in payment, will have an impact on the obligations of the sovereign under any of the sovereign's debt instruments (such as triggering cross-default provisions), or may result in attachment orders against assets of the sovereign.

Potential investors in debt securities offered by the sovereign will factor in outstanding arbitration awards in their internal risk assessment, and over time the sovereign may pay a significant risk premium for non-payment of awards.

In certain circumstances, arbitration awards can be transferred or traded on the secondary market. Governments and debt managers should follow these developments as they will likely signal a more concentrated effort by specialised funds to pursue these claims with increased vigour.

Finally, it is worth stressing that, similar to arbitration, potential litigation or actual litigation are contingent liabilities that can turn into actual liabilities for the sovereign. Some recent litigation cases against sovereigns have set forth claims in the billions, and an unexpected setback of such magnitude can have devastating consequences for a sovereign.

Good governance and prudence dictate that clear reporting obligations be established ensuring the timely reporting to debt managers of any potentially adverse arbitration or litigation claims against the country.

## Recording Contingent Liabilities

There are three elements in the ongoing monitoring of contingent liabilities:

**Internal recording:** All explicit and, to the extent possible, implicit contingent liabilities should be recorded and monitored internally by sovereign debt managers.

**External reporting:** Contingent liabilities also need to be accounted for and recorded publicly as required by applicable laws and the appropriate accounting or reporting standards. For most standards, such liabilities must be listed in a memorandum accompanying the financial statements.

**Management and monitoring:** Sovereign debt managers should monitor contingent liabilities on an ongoing basis and by reference to various base case and adverse case scenarios. Standards to monitor contingent liabilities are still evolving (these can involve complex unforeseen circumstances). There is no single solution to capturing all cases for all countries. Developing and regularly updating a framework to monitor contingent liabilities is nonetheless encouraged to enhance transparency.

# External Support for Debt Management Offices

## *Key Points*

*Developing the country's institutions and capabilities is an important aspect of sovereign debt management.*

*Capacity can be built through technical assistance from multilateral institutions and development partners, as well as through working with independent professional advisors (financial, legal and communications).*

*Advisors can assist in normal times, in difficult times and during a crisis. Their experience in similar circumstances can be highly beneficial for sovereigns facing difficulties.*

*In crises, advisors should be engaged as soon as possible and work in close collaboration with government teams.*

*Countries must ensure that the procurement of advisors complies with the relevant laws and regulations.*

# 20 Types of Assistance

Many external resources are available to support debt managers with their diverse functions. Both the official and private sectors can offer support, especially in capacity development, through technical assistance and training.

Multilateral institutions and development partners can help improve the efficiency and effectiveness of sovereign debt management, especially by developing sound legal and institutional frameworks, robust policies and strategies, and personnel training.

Private sector resources, such as independent financial, legal and communications advisors, can help debt managers develop and implement debt strategies, manage risks and processes related to specific financial transactions, and address crisis-related challenges.

## Capacity Development

Building and maintaining capacity across the debt management spectrum ensures effective debt management. Capacity can be developed through direct transaction experience, as well as through educational programmes, peer-to-peer learning, secondments and other specific training programmes.

Technical assistance involves the use of appropriate experts. Such experts can help countries resolve specific problems as they arise. They can also assist with the development and implementation of policies, protocols, programmes and projects to enhance internal decision-making processes and skills and to strengthen institutions.

Multilaterals and other Development Finance Institutions (DFIs) offer a variety of capacity-building programmes to developing countries, often at no cost or with financial support as discussed below:

### THE AFRICAN LEGAL SUPPORT FACILITY

The African Legal Support Facility (ALSF) (*https://alsf.academy/*), which has a three-level course on sovereign debt.

### THE AFRICAN DEVELOPMENT BANK

The AfDB implements a range of initiatives to enhance the skills, knowledge (*www.afdb.org/en/knowledge*) and capabilities of individuals, institutions and organisations across Africa, to empower African countries to achieve sustainable development and economic growth.

### THE INTERNATIONAL MONETARY FUND INSTITUTE

The IMF provides technical assistance and training on critical economic and policy issues (*www.imf.org/en/Capacity-Development*) to promote global economic and financial stability and sustainable growth. Through these programmes, the IMF aims to strengthen institutions, improve governance and legal frameworks and facilitate the implementation of sound economic policies. The IMF library is a key source of knowledge (*www.imf.org/en/Publications*).

### THE COMMONWEALTH SECRETARIAT

The Commonwealth Secretariat (COMSEC) is an organisation that serves as the main intergovernmental body of the Commonwealth of Nations, offering its member countries technical assistance on key development issues via the Commonwealth Fund for Technical Co-operation (CFTC). Through its *Public Debt Management Programme*, the Commonwealth Secretariat assists member countries in managing sovereign debt effectively by developing and deploying the Commonwealth Meridian, a robust Debt Management System, and policy advisory support across the functional areas.

### DEBT MANAGEMENT FACILITY

The Debt Management Facility (DMF) is a multi-donor trust fund, offering advisory services, training and peer-to-peer learning to developing countries worldwide to strengthen their debt management capacity, processes and institutions. It is administered by the World Bank and the IMF with multilateral (AfDB), regional (European Union) and Official Bilateral donors. The DMF's implementation partners include

(a) the Debt Management Programme of the United Nations Conference on Trade and Development (UNCTAD-DMFAS), (b) the Debt Management Section of the COMSEC, (c) Debt Relief International (DRI), (d) the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI) and (e) The West African Institute for Financial and Economic Management (WAIFEM).

The DMF aims to strengthen debt management to reduce debt-related vulnerabilities and improve debt transparency. The DMF facilitates collaboration among technical assistance providers on debt management and dialogue on debt issues among stakeholders. It also plays a critical role in developing and disseminating information about sound debt management practices, tools and guidance.

### THE EASTERN AND SOUTHERN AFRICAN TRADE AND DEVELOPMENT BANK

The Eastern and Southern African Trade and Development Bank (TDB) (*www.tdb-group.org*) both independently and through its capacity-building arm, TDB Academy, provides capacity-building to its member countries in various subject areas (including sovereign debt, dispute resolution and energy). The TDB Academy offers training, seminars, conferences, study tours and other human and institutional capacity development interventions in the financial and investment segments of interest to TDB and its partners.

### THE WORLD BANK MACROECONOMICS, TRADE AND INVESTMENT DEPARTMENT

The Macroeconomics, Trade and Investment (MTI) Department of the World Bank (*www.worldbank.org/en/topic/debt*) focuses on providing policy advice, technical assistance and financing to member countries related to macroeconomic stability, trade and investment promotion. The MTI department is crucial in supporting member countries' efforts to achieve sustainable economic growth, poverty reduction and inclusive development through sound macroeconomic policies, trade facilitation and investment promotion initiatives.

### THE MACROECONOMIC AND FINANCIAL MANAGEMENT INSTITUTE OF EASTERN AND SOUTHERN AFRICA (MEFMI)

The MEFMI is an intergovernmental regional capacity-building organisation (*http://mefmi.org/capacity-building-activities*). MEFMI offers a Debt Management

Programme which focuses on (a) building sustainable institutional and professional capacity in client institutions, (b) fostering the adoption of best practices in all areas of debt management and (c) raising awareness among senior and executive-level officials on key emerging challenges and opportunities in debt management.

It also provides capacity-building programmes to its member countries in macroeconomic management, fiscal policy, monetary policy, financial sector regulation and public financial management.

### THE WEST AFRICAN INSTITUTE FOR FINANCIAL AND ECONOMIC MANAGEMENT (WAIFEM)

The WAIFEM is a capacity-building institution owned by the Anglophone West African countries with a mandate to develop competencies in the fields of macroeconomics, debt, financial sector management and governance among the staff of Central Banks, ministries of finance and economic planning, debt management offices, budget offices as well as other public sector and private institutions with economic management responsibilities (*https://www.waifem-cbp.org*). WAIFEM delivers capacity-building training with the broad objectives of (a) building capacity for macroeconomic policy formulation, implementation, analysis and management; (b) strengthening capacity to manage public and publicly guaranteed external debt, private sector debt and domestic debt including contingent liabilities; (c) enhancing the skills and knowledge required for the development, regulation, management and supervision of the financial sector and strengthening capacity for the management of international reserves; and (d) enhancing transformational leadership, good governance and institutional development in member countries and the rest of West Africa.

### THE UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT (UNCTAD) DEBT MANAGEMENT AND FINANCIAL ANALYSIS SYSTEM PROGRAMME

The United Nations Conference on Trade and Development's (UNCTAD) Debt Management and Financial Analysis System (DMFAS) Programme provides technical assistance through the provision of the DMFAS software for debt recording and reporting and specialised training on debt data validation, debt statistics bulletins, debt portfolio analysis and procedures.

# Engaging Independent Professional Advisors

To ensure sound debt management across all functions, many countries — whether developed economies or LICs — hire appropriate independent professional advisors from the private sector for financial, legal and communication advisory assignments. Professional advisors bring experience, expertise, exposure and familiarity with "international best practices". Their expertise and skills are critical and can significantly affect the country's capacity to implement robust debt management frameworks and address any challenge. External advisory support is complementary to other types of assistance available to countries.

### FINANCIAL ADVISORS

International financial advisors are firms or professionals with expertise in the macroeconomic and financial issues sovereigns face. These advisors have accumulated extensive experience working with multilaterals, international regulators, official and private sector creditors, and borrowing countries around the world. They can draw on lessons learned and global best practices.

Financial advisors can provide strategic support on the design and implementation of borrowing and treasury strategies, including sustainable financing options and resolving debt distress. They can assist relevant domestic stakeholders such as Ministry of Finance officials, including debt managers, and central bankers.

Some financial advisors also offer credit rating advisory services. Such services can help countries better understand rating methodologies, engage with rating agencies, and structure liability management strategies consistent with the rating outcome.

Global or regionally focused firms may partner with qualified local experts with knowledge of the local financial markets and political and economic environment. FIG.13. summarises the main functions of financial advisors.

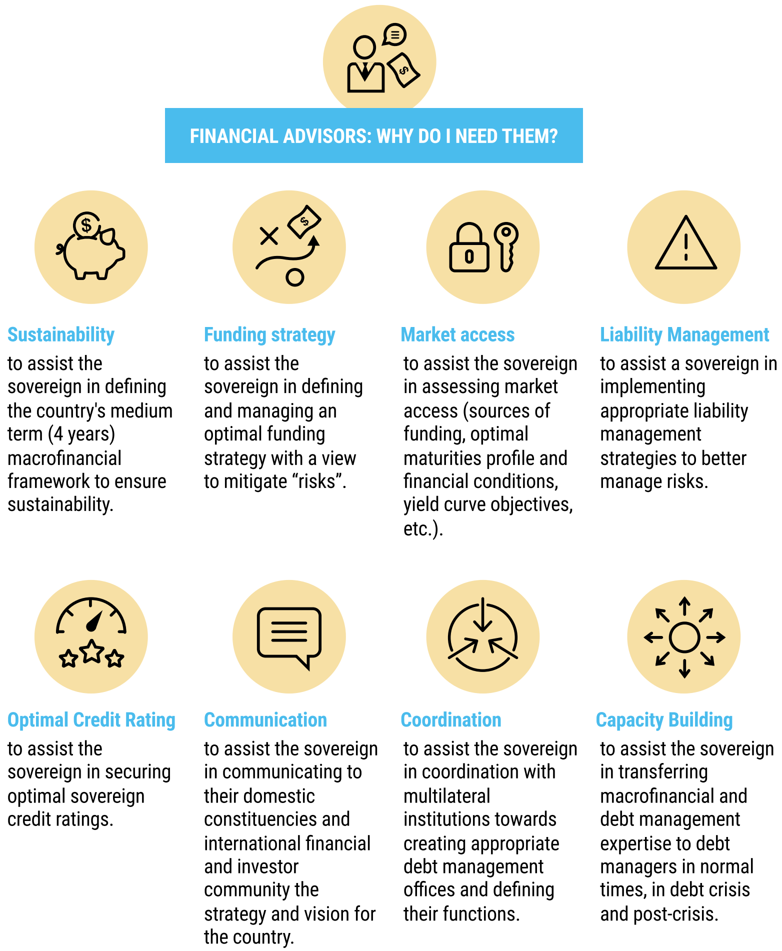



FIG. 13. Functions of Financial Advisors

## LEGAL ADVISORS

Legal advisors are reputable and experienced law firms or legal consultants who specialise in providing competent advice to countries on various legal and strategic matters, including debt financing, regulatory framework, legal risks, liability management, debt restructuring, and litigation. Legal advisors are well-versed in international best practices and the latest developments and can advise the sovereign on, for instance, the inclusion of model clauses (e.g., CACs, CRDCs) in debt agreements, and potential implications of legislative initiatives in other jurisdictions for sovereign debt restructuring.

Legal advisors will work closely with government officials including the Attorney General's office, and qualified local firms as needed.

## FINANCIAL AND LEGAL ADVISORS IN DEBT DISTRESS SITUATIONS

Appointed financial and legal advisors are typically an integral part of the government's team responsible for the country's negotiations with multilateral, official bilateral and private sector creditors.

In cases of debt distress, these advisors are important interlocutors between the sovereign team and the IMF, particularly when the country seeks or is in an IMF-supported programme. Depending on the scope of work this may include the following:

1. Financial advisors can assist the sovereign in engaging with the IMF on the assumptions underlying the IMF's DSA, which determines the amount of debt relief/financing required to restore debt sustainability and assess the appropriate debt perimeter (including, e.g., the necessity of domestic debt restructuring).
2. Legal advisors will assist in analysing the legal risks, developing the legal strategy, providing a detailed review of current debt documentation, supporting creditor engagement, preparing legal documents and managing any threatened or actual litigation.
3. Financial and legal advisors will collaborate on a coordinated engagement strategy with different categories of creditors. Their goals are (a) to ensure that any restructuring and refinancing terms comply with the IMF programme parameters and other binding constraints (such as the comparability of treatment principle applied by official bilateral creditors) and (b) to implement agreed-upon restructuring and refinancing terms.

FIG.14. illustrates the joint role of financial and legal advisors in debt-restructuring situations.


FIG. 14. The Joint Role of Financial and Legal Advisors in Debt Restructuring Situations

## COMMUNICATIONS ADVISORS

In addition to financial and legal advisors, sovereigns may consider hiring advisors specialising in media and communications. These are sometimes also referred to as Public Relations (PR) agencies. They will coordinate with the sovereign and their financial and legal advisors to ensure a transparent and credible narrative around the country's macroeconomic and financial policies, development plans, financing required or debt relief as part of its restructuring strategy. In particular, communications advisors will assist in ensuring clear messaging to:

1. Domestic stakeholders (e.g., domestic investors, non-governmental agencies, civil society and the public).
2. International investors and the international financial community (e.g., development partners and donors, current and potential foreign investors, credit rating agencies and analysts).

## Best Procurement Practices for the Selection of Advisors

Procurement rules aim to ensure that the selection process for external advisors is competitive, fair and transparent and results in the selection of experienced and reputable advisors. Procurement of these services should comply with the relevant laws and regulations of the sovereign.

Any procurement process should ideally consist of five parts, as outlined in the following diagram:


FIG. 15. Procurement Process

Following the bidding period, all proposals should be reviewed, taking into account the expertise and track record of the proposed advisors in similar advisory situations, the advisor's proposed methodology in providing the required services, and the costs of the services. All of these factors need to be appropriately balanced to identify the optimal advisor to the government.

Beyond the advisors' skills and the cost of services, the reviewer must also consider conflicts of interest issues in reviewing bids. As broadly defined, a conflict of interest exists where there is a divergence between, on the one hand, the advisor's self-interest and the advisor's relationships with and duties to third parties and, on the other hand, the government's interest in the procured services.

Any conflict of interest should be examined in detail, and the government should set parameters regarding which conflicts are acceptable and can be waived, under what conditions, and which cannot be waived.

Further, while many institutions — big and small — and individuals act as financial and legal advisors, only a handful of firms specialise in providing independent financial and legal advice to sovereign governments. In this context, it is often the best course of action to seek and obtain the advice of a disinterested, neutral party with relevant expertise, such as certain multilaterals, before engaging. For example, the ALSF can support selecting and financing legal and financial advisors for African countries.

## Available Sources of Financial Assistance for Capacity Building, Technical Assistance and Advisory Support

Governments with limited financial resources may, in some cases, seek external financing to fund the capacity building, technical assistance and engagement of external advisors needed in their countries. Several organisations, including the ALSF and the World Bank, offer such financial support.

# Debt Distress

# *Key Points*

*Acting quickly to address any risk of debt distress as soon as it arises improves a sovereign's ability to avoid or manage a crisis.*

*There are various signals when a sovereign may be heading toward a distress situation. They remain indicative but should not be overlooked.*

*Once a crisis has been acknowledged by the sovereign, a timely assessment and orderly resolution is required.*

*The critical steps to be considered include: (1) early involvement of advisors; (2) approaching the IMF and conducting a debt sustainability analysis, with the assistance of the financial advisor; (3) determining the volume and perimeter of the debt to be restructured; (4) developing a resolution strategy tailored to the nature of the crisis (liquidity v. solvency); and (5) establishing a comprehensive communications strategy to gain the necessary support from different parties.*

*Depending on their lending policies, frameworks, expectations and rights, different types of creditors require different strategies.*

*Careful consideration needs to be given to coordinating creditor engagement, proposed processes and the sequencing of the restructurings.*

*Potential unwanted surprises will linger around restructurings and continuous monitoring of the systemic implications and litigation risk is paramount.*

# 21 The Need for Timely Intervention

The precise point at which a sovereign debtor must start taking urgent steps to address a growing threat of debt distress will differ from one situation to the next. While there may be early warning signals to suggest the emergence of a problem, at a certain point, a significant disruption in the execution of a sovereign's debt management strategy will occur making it imperative to address the threat.

Monitoring signals and timely recognition of growing distress is critical as the impact of an evolving crisis can often be mitigated through early and decisive action. On the flip side, failure to recognise the need to take urgent action has been shown time and again to exacerbate the effects of a debt crisis, increasing the ultimate cost for the sovereign, its creditors and the system as a whole. Key hindrances to timely intervention include the lack of active monitoring of early warning signals, information asymmetries and lack of institutional capacity. This chapter discusses these topics.

## Recognising the Evolution of a Crisis

A crisis will ultimately lead to a complete loss of market access, i.e., the sovereign can no longer issue debt securities or access lending. However, even where there is not a full loss of market access, a crisis may increase the cost of refinancing the sovereign's debt in the local or international debt markets to levels which — in light of the debtor's specific circumstances — are unsustainable in the medium to long term. For example, investors may only be prepared to extend short-term credit at high-interest rates or on onerous secured terms. The temptation of a sovereign debt manager and other government officials will be to view this as a temporary problem that will be alleviated as time passes. However, experience shows that such situations are rarely temporary, and the sovereign should take concrete and timely steps to address the causes of the market disruption before the crisis deepens.

### SIGNALS TO KEEP ON YOUR RADAR

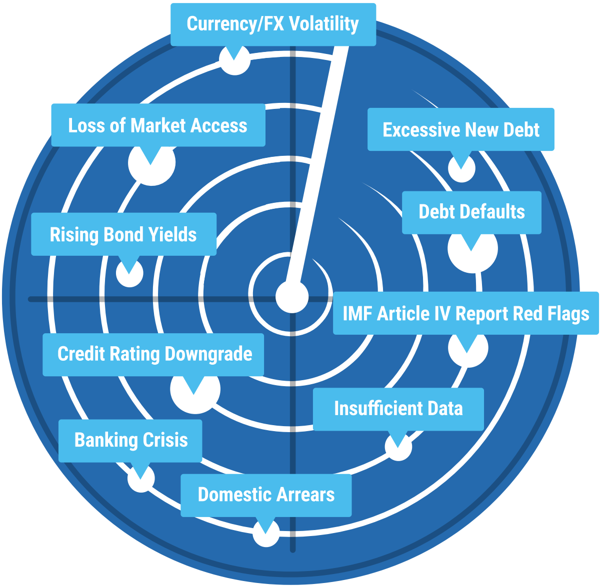



FIG. 16. Signals to Keep on Your Radar

There are a number of signals that indicate that a sovereign may be heading towards debt distress. Although the causes and severity of distress may vary, certain signals should be monitored by all prudent debt managers. These include signals that are directly monitored by debt managers in the context of a DSA, as well as those monitored by credit rating agencies, investors, lenders, multilaterals and other stakeholders. Any information asymmetry between the assessments from the sovereign, multilateral institutions, rating agencies and the market may further complicate a distress scenario.

The following is a summary of possible signals of debt distress:

- **Currency devaluation/declining FX Reserves:** A currency devaluation or rapid decline in FX reserves, relative to the composition of the sovereign's debt stock or trade balance, may be a signal of debt distress and lead to, or reflect, a loss of international confidence in the management of the economy.
- **Deteriorating debt market access:** Falling demand for a sovereign's local currency or FX-denominated debt in local or international debt markets is a signal for potential distress, as it indicates that investors are not willing to put additional capital at risk. This often arises when a sovereign is seeking to roll over or refinance maturing debt facilities.
- **Bond yields:** Falling bond prices and the inverse increase in yields can signal a rapid shift towards distress since rating agencies may reclassify bonds as having "junk status". Such a downgrade will cause many institutional investors to sell those bonds because they no longer meet the credit quality requirements of their portfolios.
- **IMF Article IV reports:** Red flags raised in IMF Article IV reports may indicate an impending or existing distress scenario. Concerns can be raised relating to exchange rate volatility, monetary, fiscal and regulatory policies, the stability of the banking system, exports and trade deficit, tax mobilisation, overall debt sustainability risks and general challenges facing the country.
- **Credit Rating Agencies :** A CRA's issuance of a negative watch or downgrade of a sovereign's credit rating is a strong indicator of distress. CRAs follow transparent and well-known criteria in their risk assessments. However, this signal may be more intermittent, as CRAs typically only issue guidance following a significant event or on a regular interval (typically 6 months).
- **Level and rate of increase of domestic arrears:** Domestic arrears are the overdue amounts the government owes to its domestic creditors, including trade creditors, suppliers, enterprises and taxpayers. They are a form of forced financing and their high levels are considered by a number of parties, from the IMF and the World Bank to the rating agencies and external investors, as a source of fiscal weakness. Their actual level (especially when noted by the IMF when it conducts its surveillance) and/or their rate of increase are signs of fiscal weakening and possible distress.
- **Default under a sovereign's debt contracts:** An event of default under one or more sovereign debt contracts is a strong indicator of potential distress, because it may enable creditors to demand early repayment or exercise other remedies.

Even if the default is rapidly remedied before creditors have taken action, debt managers should see the default event as a sign of increasing distress risk, especially since market actors will view the event as a precursor to greater financial instability.

- **Banking system crisis:** There is a saying in the world of sovereign debt restructuring — "never let a sovereign debt crisis become a banking crisis, and never let a banking crisis become a sovereign debt crisis". Even a sovereign with a positive debt outlook may be severely impacted by a crisis or collapse in its domestic banking system as the government may potentially have to intervene by recapitalising banks or assuming liability for distressed assets.
- **Materialisation of other contingent liabilities:** For example, a series of defaults under infrastructure contracts, such as failure to pay Independent Power Producers (IPPs), could trigger a sovereign debt crisis by increasing budgetary pressures during difficult times. The materialisation of a contingent liability (or several contingent liabilities) may also signal the deterioration of the macroeconomic environment and potential debt unsustainability.
- **Rapid accumulation of new sovereign debt:** New borrowing levels that exceed the sovereign's medium-term economic growth potential and corresponding debt-servicing capacity can also signal impending debt distress. Even though a small group of lenders may believe that the sovereign can service the debt, the broader market may reach a consensus as to whether the newly accumulated debt has shifted the sovereign into an unsustainable position.
- **Insufficient historical data:** The absence of historical recording and data for sovereign debt, including non-financial public sector debt and loan guarantees, should be treated as a signal of distress.

Attention should be paid to significant shifts in the periodic analysis of the sovereign's ability to service its external and domestic debt based on the evolution of debt stock and flow indicators against international benchmarks. This analysis will typically be part of a DSA by the sovereign's debt managers and/or the IMF/World Bank. In their debt analysis, other reports by these institutions will be considered by virtually all market actors.

# 22 Identifying the Nature of the Crisis

After having recognised the signals of debt distress, sovereign debt managers need to identify the nature of the problem they are facing. The response strategy will largely be guided by whether the sovereign is facing a liquidity or solvency (sustainability) crisis.

## Liquidity Crisis

In this scenario, the sovereign cannot service its debt, i.e., make payments as they become due, principally because of liquidity constraints. In essence, the country's available liquid assets (cash and cash equivalents) are insufficient to meet its maturing debt obligations and it cannot roll over its debt obligations with creditors due to, e.g., loss of market access. However, the debt is not considered unsustainable. Accordingly, the sovereign has a good prospect of regaining access to credit upon implementing appropriate policy adjustments over the medium term or upon improvement of the global macroeconomic environment. Even with the IMF, and other multilateral and/or official bilateral financial assistance, the sovereign may seek a consensual "reprofiling" of some or all of its outstanding debt with official and/or private sector creditors. The objective of reprofiling will be to extend maturity dates and/or adjust interest rates to provide space for implementing the needed macro-fiscal policy adjustments.

## Solvency (Sustainability) Crisis

In this scenario, the outcome of the IMF's DSA is that the sovereign's debt is unsustainable and the country will be unable to service it without imposing undue hardship on its economy or relying on exceptional financing sources over the medium to long term. The sovereign will not only have lost access to credit and thus be unable to roll over its maturing debts but also will likely be experiencing an acute balance-of-payments problem. To address the balance-of-payment problem, the country must obtain new financing (including from the IMF) and will be required to undertake a debt-restructuring operation to restore debt sustainability as discussed below. To develop a successful debt-restructuring plan, the sovereign must determine, in consultation with its financial and legal advisors, the appropriate strategy for restructuring some or all of its outstanding debt with official and/or private sector creditors.

# 23 Routine vs. Distress Debt Management

It is meaningful to differentiate between the normal course of liability management, a routine operation for sovereigns, from a distress scenario requiring more decisive measures to restore debt sustainability. As a result of domestic or international market disruptions, a sovereign may be subject to a short-term liquidity challenge which may require an adjustment to its existing DMS. In this situation, the economy of the sovereign remains generally healthy, its macroeconomic policies are not at issue, and the sovereign is expected to generate sufficient revenues to meet its financing needs in the medium and long term. Because of this positive outlook, market actors will not perceive this as a debt distress situation but as a temporary liquidity challenge. In this situation, a sovereign may deploy standard liability management tools, such as bridge financing, exchange offers or rollovers. Please reference the relevant chapter on "*Debt Management Strategy*" for additional insight into debt management.

In a distressed setting, the sovereign is also faced with a balance-of-payments problem. It can no longer simply rely on its liability management tools. Instead, it will have to engage in a more detailed analysis of the problem's magnitude, often with its advisors' support and through consultation with multilateral institutions such as the IMF and the World Bank.

The sovereign will then need to consider how to cover its financing gap. If possible, it may wish to approach friendly donors and development partners for grants and/or concessional financing. In exceptional circumstances, the sovereign may need to approach the IMF for financial assistance and/or seek debt relief/financing from its creditors to remedy its inability to meet its debt obligations. The form of creditor relief may include extending maturities (reprofiling), coupon reductions and/or principal haircuts (restructuring). In all cases, the sovereign must adopt a programme to implement policy adjustments and reforms supported by IMF financing. This provides creditors with the confidence that relief/financing will allow the sovereign to exit the distress scenario, return to economic growth and regain market access.

Below is a general overview of the management, consultation, assessment and resolution process in a distress scenario.

# 24 How Do I Manage Debt Distress Situations?

## The Team

The management of a debt distress situation requires a dedicated team (strategy team) and a plan. Putting together a team to lead and manage the sovereign's efforts will increase its ability to resolve the difficulties quickly. It should be the first step in handling the crisis, to be taken without delay, as time will only exacerbate the difficulties and the inevitable deadweight losses that the crisis will bring.

The team, likely to be established on an *ad hoc* basis at the Ministry of Finance, will need to have the necessary resources and support to be able to deliver on the tasks ahead. Its members must have both the expertise and the authority to design, decide and implement the solutions. Relevant government departments and agencies including the Attorney General's office, the Central Bank, debt managers and managers of systemic SOEs, as appropriate, should be ready to work together to assist the team.

## Appointment of External Advisors

The sovereign should hire experienced financial and legal advisors to help assess its financial and legal options. Such advisors should be experienced in sovereign debt restructuring to support the sovereign in navigating the forthcoming process. Delaying the appointment of such advisors can make it difficult for the strategy team to respond optimally to a rapidly evolving situation. Please refer to the Section "External Support for Debt Management Offices" for a detailed discussion.

## Action Plan

When faced with difficulties in debt management, a sovereign must undertake a series of actions to facilitate a timely assessment and orderly resolution of the crisis. The strategy team will first assess the severity of debt distress and its causes and prepare an updated DSA to determine necessary interventions. The support of external advisors and ongoing consultation with multilateral institutions such as the IMF and the World Bank will help establish key data points. That consultation will also include determining the outstanding debt and any imminent debt payment obligations, and forecasts of the fiscal and macroeconomic trajectory under a range of assumptions. Based on this analysis of debt and payment amounts, the sovereign should establish the perimeter of the debt to restructure and develop a resolution strategy.

Although the communications strategy is typically established once the restructuring perimeter is set, it is paramount to sensitise the strategy team and other government officials to the importance of coordinating formal and informal communication with the media, creditors, key stakeholders and other actors of the markets. The sovereign may consider hiring a communications advisor. Reference the relevant chapter on "*Types of Assistance*". It is preferred to limit communications until a strategy is established as discussed in more detail below.

Finally, the sovereign needs to assess the potential systemic implications of this distress resolution strategy (e.g., for the banking sector) and the required political support to adopt and implement the difficult policy decisions needed. Although this process may be complex and difficult to manage, a transparent and orderly resolution of debt problems can avoid unnecessary delays and reduce potential pitfalls with serious social implications.

## Pitfalls to Avoid

Political and other pressures will often be imposed on sovereign debt managers and responsible government officials to delay necessary — but painful and unpopular — measures to address debt distress. Efforts to avoid making these difficult decisions often exacerbate the problem. Examples of poor practice in managing a sovereign debt crisis include (a) providing creditors with access to strategic state resources or assets (including collateralised or quasi-collateralised structures) in return for lending commitments; (b) forcing domestic pension funds to invest a percentage of their portfolio in sovereign debt; (c) requiring local banks to extend credit lines to the government; (d) rolling over maturing longer-term international debt obligations with shorter-term domestic debt; and/or (e) conducting fire sales of state assets to raise cash for repaying debt.

For instance, some countries facing debt distress enter into financing agreements with commercial banks secured by bonds issued by the debtor and the collateral is marked-to-market. When distress mounts and the price of the underlying bonds declines, the sovereign is forced to top up or repay the original facility in full at the risk of precipitating the crisis.

## IMF Consultation Process

The strategy team should approach the IMF to evaluate the options available to address a debt crisis. The type of IMF financial assistance that may be available to the sovereign in this situation, and the conditions for provision of such financial assistance, will depend on the outcome of the IMF's DSA and other relevant policies. If the DSA concludes that the sovereign's debt is unsustainable, the IMF will not be able to provide financial assistance to the sovereign debtor unless it takes specific steps to restore sustainability. It will be up to the sovereign to decide whether and when to restructure its debt.

In either case, in consultation with the IMF staff, the sovereign will need to develop a macroeconomic framework that includes the overall financing envelope, parameters and conditions of IMF financing, including fiscal and structural adjustments that the sovereign must undertake. This framework will guide the negotiations between the sovereign and its creditors, as may be required.

The IMF can provide financing in a pre-default or post-default context, subject to certain conditions. For instance, in a pre-default context, (a) with respect to private sector creditors, the IMF needs to have confidence that a credible process for restructuring is underway to achieve sufficient creditor participation to restore sustainability, and (b) with respect to official bilateral creditors, the IMF needs to receive specific and credible assurances on debt relief/concessional financing consistent with programme parameters.

In the post-default scenario where the sovereign has accumulated external arrears to creditors, the IMF can only provide financing to the sovereign if the IMF's arrears policies (i.e., non-toleration of arrears to multilateral creditors, lending into arrears to official bilateral creditors and lending into arrears to private creditors) are satisfied. In both pre- and post-default contexts, the IMF can lend before a debt restructuring is completed.

Where a sovereign does not need immediate IMF financial assistance or if such assistance is not available, it remains possible to negotiate a debt restructuring with its creditors without the anchor of an IMF-supported programme. However, this is generally a lengthier and more complex process.

## Strategy Development

Having appointed financial, legal and communications advisors and consulted the IMF to determine the nature and terms of the financial assistance that may be available to it, the strategy team should then take four key steps as a precursor to the implementation of a necessary debt restructuring operation: (1) define the perimeter of sovereign debt to be included in the forthcoming debt restructuring operation; (2) review the terms of the existing debt instruments to consider, in particular, provisions on cross-default, creditor consent, state immunity and litigation vulnerabilities; (3) assess the sovereign's litigation risks and asset protection priorities; and (4) agree on a communications strategy towards creditors and other stakeholders.

### RESTRUCTURING PERIMETER

A critical step for the sovereign is to define the perimeter of the debts to be restructured. The perimeter needs to be informed by the financing envelope defined under the IMF-supported programme. It is advisable that the sovereign attempts to define the widest possible debt perimeter to maximise debt relief and ensure inter-creditor equity. Where categories of domestic debt are proposed to be included in the perimeter, additional considerations relating to the preservation of financial stability and related prudential issues must also be taken into account.

Careful consideration should be given to the categories of debt which will not be included in the restructuring. The exclusion of any category of debt or creditor from the restructuring perimeter should be consistent with generally accepted practices (e.g., multilateral debt and short-term trade finance) and without materially compromising the goals of debt relief maximisation and equal treatment of creditors.

In the debt identification exercise, the sovereign should determine the appropriate treatment of the various categories of debt with the relevant creditors. The design needs to ensure inter-creditor equity so as to achieve high participation in the restructuring.

### DOCUMENTARY REVIEW

If the sovereign has not declared a moratorium and the anticipated restructuring is intended to be done ahead of payment or other defaults, the sovereign and its advisors must promptly review the terms of the sovereign's existing debt instruments to ensure that such a strategy is feasible. In all circumstances, the sovereign and its advisors should also review the terms of the debt instruments within the restructuring perimeter to ensure that the anticipated strategies for creditor participation and asset protection can be implemented and litigation vulnerabilities identified.

### LITIGATION RISKS AND ASSET PROTECTION

Commercial creditors regularly sue to recover their claims. In particular, distressed debt investors and specialised litigation funders have shown little hesitation in pursuing sovereign debtors. In most cases, obtaining a debt judgment on the non-payment of contracted sovereign debt is straightforward. However, enforcing the judgment is a completely different story.

Although the litigator's imagination has no boundaries, the sovereign usually does not have many attachable assets abroad and the strategy team should take steps to protect those overseas assets. Some sovereign assets benefit from statutory immunity under international conventions (e.g., diplomatic and military assets). Contractual provisions can be included in debt contracts to afford immunity to commercial and other assets not entitled to statutory immunity protection.

> **Protecting sovereign assets during debt distress**
>
> When the debt is initially being negotiated and documented, the sovereign should ensure — with the support of its legal advisors — that overseas assets of national importance or particular sensitivity benefit from either statutory or contractual immunity protection (e.g., diplomatic missions, military bases, etc.).

In crisis management, the strategy team should identify, with the assistance of its legal advisors, the "vulnerable" non-resident assets (e.g., Central Bank foreign exchange reserves/deposits/assets, SOEs' assets located outside the jurisdiction) and conduct a proper analysis of the legal risk of attachment of such assets by judgment creditors. This involves an analysis of the protections afforded by principles of sovereign immunity for state assets in the jurisdictions where the assets are located.

## COMMUNICATIONS AND OUTREACH STRATEGY

Once the perimeter of the debt restructuring operation has been established, the strategy team in coordination with other government officials or authorities should develop and implement an effective external communications strategy. The strategy should create a conducive environment for a constructive resolution of the debt situation. Specifically, the sovereign should convey clear and consistent objectives of the debt-restructuring process and the proposed treatment of different categories of creditors, including the relevant targets embedded in IMF-supported programmes. Legal and financial advisors can help greatly in carefully crafting the information that the strategy team wants to convey.

# 25 Techniques of Debt Restructuring

Once the sovereign decides to restructure some or all of its debt, whether to address liquidity or sustainability concerns, it will need to develop a restructuring strategy tailored to the characteristics of the affected creditor categories.

## Official Bilateral Creditors

A sovereign should first consider who its official bilateral creditors are (e.g., whether they are members of the Paris Club), what percentage of the debt stock each represents and whether the country is eligible for specific initiatives such as the Common Framework.

Based on this information, debt managers can consult with their advisors to choose the most expedient mechanism for engaging with official bilateral creditors to streamline the discussions and expedite the process.

### PARIS CLUB

The sovereign may decide to approach the Paris Club to seek rescheduling of its government-to-government debt to Paris Club creditors. The precondition for a Paris Club rescheduling is that the country must have an IMF-supported programme. The Paris Club has established a menu of options for sovereigns in debt distress, referred to as different "treatments". These options include rescheduling, which is debt relief by postponement of maturities or, in the case of concessional rescheduling, reduction in debt service obligations during a defined period (flow treatment) or as of a set date (stock treatment). The modality of debt treatment, cut-off date and consolidation period depend on the financing gap identified in the IMF-supported programme. In deciding debt treatment, the Paris Club takes into account the country's past track record, both on servicing its debts and its performance under an IMF-supported programme, and the contribution expected from other external creditors (multilateral creditors, private creditors, and non-Paris Club official sector creditors).

## The Paris Club

The Paris Club is a group of official bilateral creditors that has met regularly in Paris since 1956 and coordinates the sovereign debt restructurings of EMDEs. There are currently **22 permanent members** of the Paris Club: Australia, Austria, Belgium, Brazil, Canada, Denmark, Finland, France, Germany, Ireland, Israel, Italy, Japan, South Korea, the Netherlands, Norway, the Russian Federation, Spain, Sweden, Switzerland, the United Kingdom and the United States of America. Other countries which are not members can also participate in Paris Club debt treatments on an ad hoc basis.

The Paris Club is currently the only representative standing forum that the IMF acknowledges in its arrears or financing assurances policies, which can have major importance for debtors when seeking an IMF programme. It also plays an important function in the secretariat for Common Framework debt treatments.

The strategy team and the Paris Club creditors will work towards a consensus which reflects the IMF DSA. Once a consensus is reached, the terms of the treatment will be recorded in a document called the Agreed Minutes prepared by the Paris Club Secretariat and then approved by the Paris Club creditors and the sovereign debtor. Completion of the restructuring process requires that the sovereign debtor enter into bilateral agreements with each Paris Club creditor country to implement debt relief no less favourable to the sovereign than what is contemplated in the Agreed Minutes. The Agreed Minutes impose on the sovereign a comparability of treatment obligation to conclude agreements with each of its non-Paris Club creditors on no less favourable terms.

### COMMON FRAMEWORK

The Common Framework is an initiative launched by the G20 to bring together all G20 official creditors in a single forum to agree on a common debt treatment of eligible countries in a timely and orderly manner. The 73 low-income and IDA-eligible countries eligible for the DSSI are also eligible for the Common Framework.

When a country applies for debt treatment under the Common Framework, its G20 official creditors — and other official creditors voluntarily — will form an Official Creditor Committee (OCC). The OCC will then agree on an appropriate debt treatment based on the IMF DSA. The Common Framework process requires the requesting country to have an IMF-supported programme, which defines the restructuring envelope.

Once the OCC reaches an agreement on the parameters of the debt treatment, the agreement will be enshrined in a non-legally binding *memorandum of understanding* (MoU). Based on this MoU, the debtor must engage each OCC member individually to sign final loan-level restructuring agreements.

The Common Framework MoUs also feature non-financial clauses, which include enforcement mechanisms for the comparability of treatment principles such as claw-back clauses and a commitment from the debtor not to start repaying any creditor that has not agreed on comparable debt treatment.

### AD HOC COORDINATION

When a sovereign is not eligible for or does not wish to apply for debt treatment under the Common Framework, the strategy team may decide to engage with creditors through an ad hoc framework with rules similar to those of the Paris Club or the Common Framework.

### BILATERAL NEGOTIATIONS

Bilateral negotiations might be necessary in specific cases. For instance, they could be required when the sovereign has a very limited number of official bilateral creditors or if an official bilateral creditor holds a significant portion of the debtor's debt stock. Also, some official bilateral creditors may prefer bilateral discussions to capture the specificities of their outstanding claims better.

However, the multiplicity of bilateral negotiation channels can create a significant and unnecessary burden for the strategy team. It can also lengthen the process and increase coordination challenges.

## Holders of Local Currency Debt

Local currency debt holders include various stakeholders with varying incentives, objectives, preferences and bargaining powers. The strategy team should consider these specificities when engaging in restructuring negotiations.

### DOMESTIC FINANCIAL SECTOR

Domestic investors in local currency bonds often include domestic banks, pension funds and insurance companies. When deciding whether to restructure bonds held by these institutions, careful consideration needs to be given to the potential consequences. These consequences may include an adverse impact on banking sector stability and the viability of pension funds and insurance companies, which may further affect the domestic political economy.

### CENTRAL BANK

Central Bank holdings of domestic debt securities can be included in the perimeter of the restructuring, which can reduce the equity of the Central Bank and in some instances even push it into a negative capital position. There is empirical evidence however of some loss absorption capacity for Central Banks in such a context as some countries have managed to significantly reduce the claims owed by a government to their Central Bank with little to no adverse effects on their credibility and ability to implement monetary policy.

### NON-RESIDENT HOLDERS OF DOMESTIC DEBT SECURITIES

Pressures can arise to restructure the domestic-currency debt securities held by non-resident holders. For instance, for the IMF DSA for low-income countries conducted on residency, such holdings will be classified in the external debt bucket, requiring additional effort from other creditors covered in the perimeter to achieve the restructuring targets.

Including only non-resident holders of domestic debt in the restructuring can avoid some of the financial stability and systemic issues that arise when domestic holders of such instruments are included in the perimeter. But it creates additional legal and operational challenges. For instance, it may be difficult to specifically identify such non-resident holders in treasury and Central Bank records and the ownership and trading of such securities may be difficult to restrict. In addition, there are legal risks under bilateral and other international investment treaties associated with discriminating in debt treatment between resident and non-resident holders. Legal advice should be sought in this regard.

## External Bondholders

A wide range of investors hold bonds issued in international capital markets — sometimes thousands of them — around the world, making it impossible for a debtor to engage individually with each of them. Therefore, the common practice is for bondholders to coordinate through formal or ad hoc committees, providing a point of contact for engagement with the debtor.

Individual bondholders may still be incentivised not to participate in the restructuring to recover payment on the full contractual claims (holdouts). However, the sovereign can rely on CACs which have become the market standard in international bond documents to address the holdout problem. With the assistance of financial and legal advisors, the sovereign needs to decide whether to negotiate with a formal or ad hoc creditor committee or a few individual large creditors who will be willing to engage in, and potentially publicly endorse a debt resolution exercise. It is important to note that the modality of engagement should remain flexible to achieve an orderly restructuring in a reasonable timeframe through good faith negotiations. Where the debt securities being restructured include publicly traded and listed bonds, the sovereign needs to be cognisant of issues relating to the selective sharing of material nonpublic information (MNPI) with creditors during negotiations. Legal advice needs to be sought to ensure the sovereign at all times complies with its duties with respect to MNPI under applicable securities laws and regulations.

The market has developed tools to mitigate the collective action problem and enable broad creditor participation. Restructurings are now usually structured as voluntary debt exchanges. A number of techniques facilitate these effective "liability management" debt exchanges. These tools and techniques include:

1. CACs allow a qualified majority of bondholders to bind all bondholders to modify key bond terms.
2. Exit consents allow a majority of bondholders to modify the non-payment terms (e.g., sovereign immunity, governing law, a listing of the bonds ) of old bonds that are being tendered in a voluntary exchange offer. This forces other

bondholders to participate in the restructuring or face the prospect of ending up with less attractive bonds.
3. Minimum participation thresholds are designed to assure creditors that the debtor would only proceed with the debt exchange if a qualified majority of creditors participate.
4. Contractual enhancements granting better protection for creditors (e.g., principal reinstatement, mandatory pre-payment, and financial covenants).
5. Credit enhancements such as upfront cash repayments, cash-equivalent notes and add-ons to the new instruments can produce an additional payment (e.g., GDP-linked warrants or commodity-linked value recovery rights, also broadly referred to as state-contingent debt instruments). For more details on state-contingent debt instruments (SCDIs), please refer to the ALSF's Debt Guide on SCDIs.
6. Regulatory sweeteners (e.g., tax benefits, beneficial liability treatment for regulatory capital, lenient treatment of defaulted obligations by insurance companies).

## Non-Bond External Commercial Creditors

The universe of non-bond external commercial creditors is wide and includes loans extended by commercial banks, commodity traders and regional financial institutions. These loans can also be syndicated. This category also increasingly includes state-owned commercial banks, which blurs the lines between official and private sector creditors, sometimes complicating the negotiations across different channels.

Commercial banks are sometimes called the London Club during the restructuring process. The reference to "London" is historic and was selected to juxtapose the private-sector nature of these creditors, who used to be mostly based in London, from the official sector lenders of the "Paris Club".

As discussed in the Section "Types of Creditors", some regional financial institutions have increased their lending to African countries. The treatment of their debts may be complicated in a debt restructuring, as they often argue that they should be excluded from the restructuring perimeter or enjoy improved treatment compared with commercial creditors.

In general, there is no pre-defined mechanism to coordinate the restructuring of non-bond commercial creditors, meaning the sovereign will have to negotiate restructuring terms bilaterally with every one of them. While this would be done voluntarily, the sovereign can be constrained by requirements such as the IMF DSA targets or comparability of treatment provisions, requiring directly or indirectly including such creditors in the restructuring perimeter.

In the case of syndicated loans, the sovereign should approach the syndicate agent to negotiate a restructuring of commercial loans, which may follow a set of best practices or principles accepted in the market. Any changes to payment or other fundamental commercial terms generally require the consent of each lender in the syndicate. While the G7 Working Group recently proposed the Majority Voting Provisions (MVP) model for amending payment terms, as of the date of this publication, these provisions have not yet been adopted in any syndicated loan agreement.

The diagram below summarises key steps and options for resolving distressed sovereign debt situations.

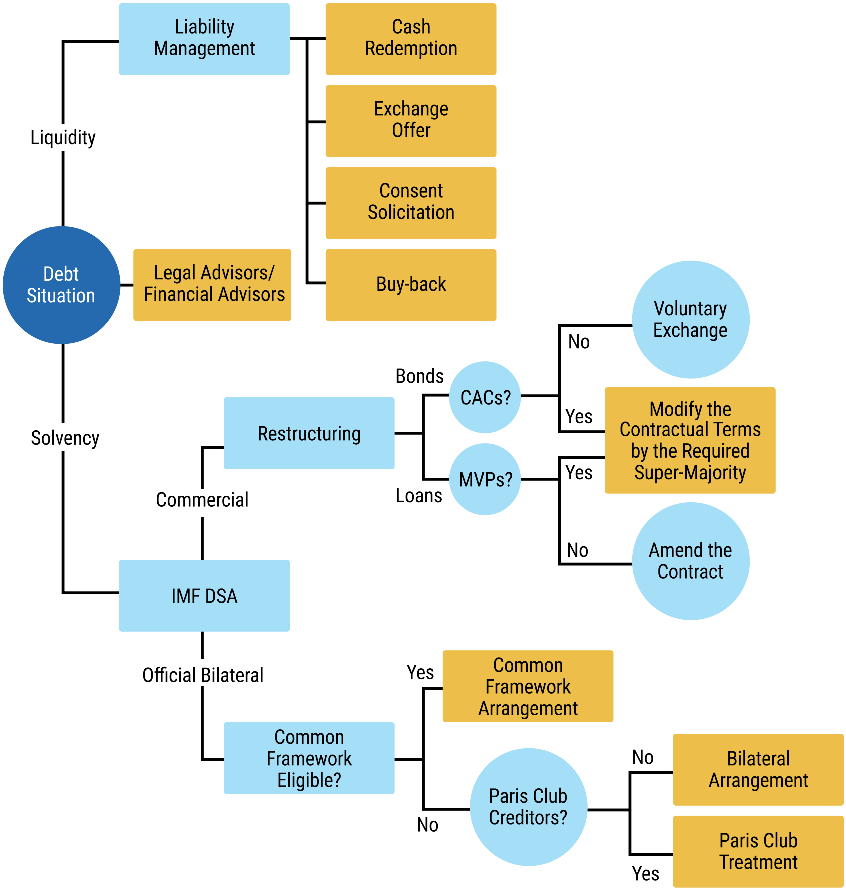



FIG. 17. Decision Tree for Resolving Sovereign Debt Distress

## Inter-Creditor Equity and Comparability of Treatment

Inter-creditor equity is a key principle of sovereign debt restructurings. It allows for equitable burden sharing and thus facilitates a timely and orderly conclusion of the negotiations. In the absence of a sovereign insolvency regime, the principle seeks to ensure that all creditors of a distressed sovereign are treated fairly and equitably during the debt restructuring process. Private creditors and other stakeholders have espoused and promulgated this principle through the Institute for International Finance's Principles for Stable Capital Flows and Fair Debt Restructuring.

A related principle is that of Comparability of Treatment (CoT). CoT provisions are routinely included in agreements between a debtor and its official bilateral creditors. Such provisions typically require the debtor to commit to seeking debt treatment from other creditors within the restructuring perimeter on terms, at least, as favourable as those offered by the respective creditor. As part of the Common Framework, CoT provisions have been paired with enforcement mechanisms such as claw-back clauses and commitments by the debtor not to restart payments to creditors before they agree on a comparable debt treatment.

The principle of inter-creditor equity — and to an extent the CoT — can be expressed through both contractual and non-contractual mechanisms. For example, so-called "most favoured creditor clauses" (MFCC) or "rights upon future offer" (RUFO) clauses have been included in private sector restructuring documentation to ensure that holdouts receive no better treatment from the sovereign debtor than the creditors who participate in the restructuring. Sovereign debtors have also made public statements on non-legally binding commitment to key stakeholders that holdout creditors will not receive advantageous treatment as compared with "first movers".

## A Note on Odious Debt

Though occasionally referenced by civil society, odious debt is not a recognised legal principle under international law. As such, a sovereign cannot rely on this principle to repudiate its debt obligations.

# 26 Recovery and Resilience

## Recovering Sustainability

Falling borrowing costs, recovery in bond prices, increased investor appetite and improvement of any other previously negative signals are likely to indicate that the sovereign's debt management and/or restructuring strategy has succeeded. However, as with the initial risk analysis, the sovereign should be careful not to interpret a temporary improvement in financing conditions as an indication of long-term recovery. The sovereign should continue to conduct its own sustainability analysis and consult with multilateral development banks, the IMF and creditors to confirm creditor and market sentiments on the sovereign's recovery in the domestic and international markets.

The years following the restructuring can provide idiosyncratic opportunities for liability management exercises. For instance, new bonds issued in the restructuring may trade at a significant discount before yields gradually come down, which could be conducive to executing debt-swap opportunities. Opportunities should be seized to proactively tackle refinancing risks, in instances where debt amortisation might pick up sharply after the IMF-supported programme ends.

## Realising Resilience

A debt crisis is a very painful shock, for which the political, economic and social consequences cannot be underestimated. It is generally an expensive experience that the sovereign and its citizens will desire never to repeat.

The shared recognition of the economic disruption caused by a sovereign debt crisis often gives the sovereign a window of opportunity to build resilience against the next challenge. There is an adage — "never let a good crisis go to waste". At the policy level, the government may use the crisis to help overcome political resistance to unpopular reforms, including rationalising public subsidies, reducing fiscal deficits and more rigorous execution of capital expenditure programmes. The government may also take the opportunity to improve its macroeconomic management by updating fiscal rules and debt management policies and operations and embracing broader debt transparency. Taking these steps will help avoid a recurrence of the conditions which led to the crisis and offer the prospect of a brighter and more stable future.

# Acronyms

| | |
|---|---|
| ABP | Annual Borrowing Plans |
| ADF | African Development Fund |
| AFC | Africa Finance Corporation |
| AfDB | African Development Bank |
| Afrexim | African Export-Import Bank |
| ALSF | African Legal Support Facility |
| BOAD | West African Development Bank |
| CACs | Collective Action Clauses |
| CAT DDO | Catastrophe Deferred Drawdown Option |
| CFTC | Commonwealth Fund for Technical Co-operation |
| China EXIM | China Export-Import Bank |
| COMSEC | Commonwealth Secretariat |
| CoT | Comparability of Treatment |
| COVID-19 | Coronavirus Disease 2019 Pandemic |
| CRAs | Credit Rating Agencies |
| CRDCs | Climate-resilient Debt Clauses |
| DMF | Debt Management Facility |
| DMO | Debt Management Office |

| | |
|---|---|
| DMS | Debt Management Strategy |
| DOD | Debt Outstanding and Disbursed |
| DRI | Debt Relief International |
| DSA | Debt Sustainability Analysis |
| DSSI | Debt Service Suspension Initiative |
| DTC | Depository Trust Company |
| ECOWAS | Economic Community of West African States |
| EMDEs | Emerging Markets and Developing Economies |
| ESG | Environmental, Social, and Governance |
| GDP | Gross Domestic Product |
| GNI | Gross National Income |
| GRA | General Resources Account |
| GSDR | Global Sovereign Debt Roundtable |
| HIPC | Heavily Indebted Poor Countries |
| IBRD | International Bank for Reconstruction and Development |
| ICMA | International Capital Markets Association |
| ICSID | International Centre for Settlement of Investment Disputes |
| IDA | International Development Association |
| IFC | International Finance Corporation |
| IMF | International Monetary Fund |
| IR | Investor Relations |
| ISDA | International Swaps and Derivatives Association, Inc. |
| ISSAIs | International Standards of Supreme Audit Institutions |
| LICs | Low-income Countries |

| | |
|---|---|
| LMA | Loan Market Association |
| MAC | Market Access Countries |
| MDB | Multilateral Development Bank |
| MDRI | Multilateral Debt Relief Initiative |
| MEFMI | Macroeconomic and Financial Management Institute of Eastern and Southern Africa |
| MIGA | Multilateral Investment Guarantee Agency |
| NSGLs | Non-Sovereign-Guaranteed Loans |
| NTF | Nigerian Trust Fund |
| OCC | Official Creditor Committee |
| ODA | Official Development Assistance |
| OECD | Organisation for Economic Co-operation and Development |
| OTC | Over-The-Counter |
| PCS | Preferred Creditor Status |
| PCG | Partial Credit Guarantee |
| PPPs | Public-Private Partnerships |
| PRGT | Poverty Reduction and Growth Trust |
| PSWG | Private Sector Working Group |
| RMC | Regional Member Countries |
| RST | Resilience and Sustainability Trust |
| SAIs | Supreme Audit Institutions |
| SAPs | Structural Adjustment Programmes |
| SDGs | Sustainable Development Goals |
| SDR | Special Drawing Right |

| | |
|---|---|
| SGLs | Sovereign-Guaranteed Loans |
| SLBs | Sustainability-Linked Bonds |
| SLCLs | Synthetic Local Currency Loans |
| SOEs | State-Owned Enterprises |
| SONIA | Sterling Overnight Index Average |
| SOFR | Secured Overnight Financing Rate |
| TDB | The Eastern and Southern African Trade and Development Bank |
| UNCTAD | United Nations Conference on Trade and Development |
| UNCTAD-DMFAS | Debt Management Program of the United Nations Conference on Trade and Development |
| USD | United States Dollar |
| US EXIM | US Export-Import Bank |
| WAIFEM | West African Institute for Financial and Economic Management |

# Glossary

## Acceleration

a clause in a contract, typically a loan or a bond, allowing a creditor to request earlier repayment of the debt if a stated event occurs. For example, if a borrower defaults on two or more payments, an acceleration clause may allow a lender to force the borrower to repay the entire loan or bond amount immediately.

## Agent

the financial institution acting as a representative of the lenders under a syndicated loan. The agent's role is to administrate the loan, take specified decisions on behalf of the lenders, provide the lenders with the information necessary for their decisions, and enforce the contract in the event of default.

## Arranger

the financial institution engaged by a borrower to arrange the issuance of debt in the capital markets.

## Balance of payments

a statement of all transactions made between entities in one country and the rest of the world over a defined period of time, such as a quarter or a year.

## Bilateral Investment Treaties (BITs)

an agreement establishing the terms and conditions for private investments by nationals and companies of one State in another State.

## Blue bond

debt instrument issued by a borrower to finance marine and ocean-based projects with positive environmental, economic and climate benefits. The blue bond is inspired by the green bond concept.

## Bridge financing

an interim financing option (often in the form of a bridge loan) used by companies and other entities to solve short-term liquidity issues until a long-term financing option can be arranged.

## Callable bond

a bond that can be redeemed by the issuer earlier than its maturity date.

## Catastrophe bond (Cat bond)

catastrophe-related insurance-linked security (ILS) which pays periodic coupons to the investors during the bond's life. Concurrently, they provide the insured entity (sponsor) insurance coverage against a predefined set of eligible events. Sovereign cat bonds have been developed to provide financial protection against hazards such as hurricanes, earthquakes, excess rainfall and pandemic risk.

## Climate Resilient Debt Clause (CRDC)

a contractual provision enabling the borrower to temporarily defer debt service payments (principal and/or interest) for a pre-agreed period when a predefined event occurs. It is also known as a natural disaster or debt pause clause and can be used for non-climate-related shocks.

## Collateral

an asset that a borrower offers as security for a loan.

## Collective Action Clauses (CACs)

provisions in bond contracts that allow a majority of bondholders to agree to a debt restructuring that is legally binding on all bondholders, including those who voted against the agreement.

## Commodity-backed bond

a bond for which the price is linked to the price of a commodity.

## Common Framework

mechanism created by the G20 to coordinate among official creditors for the restructuring of the debt of eligible low-income countries.

## Contingent liability

a potential liability which can become an actual liability upon the occurrence of an uncertain future event.

## Coupon

the periodic payment of interest paid to the holder of a bond.

## Counter guarantee

an agreement in which a third party promises to fulfil the payment obligations of a guarantor if the original guarantor fails to do so.

## Credit rating agency (CRA)

an institution that provides investors with information and ratings about a borrower's ability to meet its obligations.

## Credit risk

the risk that the borrower defaults under its financial obligations.

## Cross-currency swap

an OTC derivative agreement between two parties to exchange interest payments and principal denominated in two different currencies.

## Debt restructuring

a process where the debtors negotiate with creditors to reduce the loan's interest rate, extend its repayment term or cut its balance, in order to avoid the risk of defaulting.

## Debt sustainability

the ability of a government to meet its debt obligations without requiring debt relief or accumulating arrears.

## Debt Sustainability Framework (DSF)

a framework for a country's borrowing decisions to meet their financing needs while maintaining debt sustainability. The DSF provides a framework in Excel format for analysing the debt and debt service dynamics under a baseline scenario and a set of standardised economic shocks.

## Debt Management Performance Assessment (DeMPA)

a methodology developed by the World Bank to help countries assess their sovereign debt management operations against internationally recognised standards and best practices.

## Debt Service Suspension Initiative (DSSI)

G20 initiative launched in 2020 to reschedule the debt payments due by a list of low-income countries to their official creditors.

## EURIBOR

daily referenced interest rate used for lending between banks on the European interbank market. It is also used as a reference for setting interest rates on loans.

## Eurobond

an international bond issue denominated in a currency not native to the country where it is issued. It can be categorised according to the currency in which it is issued. Eurobonds are named after the currency in which they are denominated. For example, Euroyen and Eurodollar bonds are denominated in Japanese yen and US dollars respectively.

## Event of Default

a specific condition or event defined in a loan or bond agreement that, if it occurs, gives the lender the right to demand immediate repayment of the loan or take legal action to enforce the agreement.

## Export Credit Agency (ECA)

known in trade finance as an "ECA" or investment insurance agency is a private or quasi-government institution that acts as an intermediary between national governments and exporters to issue export financing. The financing can take the form of credit or credit insurance and guarantees or both, depending on the mandate the ECA has been given. ECA can also offer credit or cover of their own account. Some agencies are government sponsors, some are private and others combine the two.

## Export credits

loan facility extended to an exporter by a bank in the exporter country. i.e., under a "buy now, pay later" arrangement.

## Green bond

a bond that is specifically earmarked to be used for climate and environmental projects.

## Gross Domestic Product (GDP)

the estimated total value of all the finished goods and services produced within a country's borders in a specific time period.

## International/Development Finance Institutions (IFI/DFI)

specialised development banks/institutions with the ability to raise large amounts of money to provide financing for development projects, programmes or initiatives for developing countries.

## Issuer

a legal entity such as a corporation, government or government agency that issues and sells securities to finance its own operations.

## Judgment creditor

a creditor who has proved its debt in a legal proceeding and who is entitled to use the judicial process to collect it.

## Limited recourse financing

financing for which the creditor has limited claims on the borrower in the event of default.

## Liquidity Risk

financial risk that for a certain period of time, a given financial asset, security or commodity cannot be traded quickly enough in the market without impacting the market price.

## Market Access Countries (MACs)

countries typically have significant access to international capital markets as opposed to countries which meet their external financing needs mostly through concessional financing.

## Market Risk

risk associated with the possibility of adverse changes in interest rates, foreign currency exchange rates or commodity prices.

## Mortgage

a debt instrument, secured by the collateral of specified real estate property, that the borrower is obliged to pay back with a pre-determined set of payments.

## Multilateral Loan

loan funded by an IFI/DFI.

## Par value

the face value of a bond, i.e., the value of the principal repayable at maturity.

## Premium

the excess value added to the price or cost of a financial asset.

## Primary market

market, also known as the "New Issue Market", is where the borrower initially issues and sells new securities.

## Private sector

part of the economy is run by individuals and companies for profit and is not state-controlled and therefore comprises businesses that are not owned or operated by the government.

## Private sector loans

loans that are granted by commercial banks (and sometimes funds) on specific terms.

## Project bond

type of bond that ensures that the proceeds of a bond will be used for a specific project.

## Public and Publicly Guaranteed Debt (PPG)

the IMF uses the category of debt in its DSA analysis. It includes the general government debt and the debt of SOEs that do not have financial or administrative autonomy.

## Public sector

the general government sector plus government-controlled entities, known as public corporations, primarily engage in commercial activities.

## Public sector debt

the aggregate of central government debt and SOE debt.

## Refinancing Risk

risk associated with the maturity of an obligation that may not be refinanced or only at a higher cost.

## Request for Expression of Interest (RfEoI)

a solicited invitation from the procuring entity to potential bidders to express interest in a project, mandate or the delivery of services.

## Request for Proposal (RfP)

a solicited invitation from the procuring entity to potential bidders to submit a proposal for a project, mandate or the delivery of services.

## Revolving Facility

a type of credit line that allows the borrower to withdraw, repay, and reborrow funds up to a specified limit during the term of the facility, often used for short-term working capital needs.

## Roadshow

a series of presentations made to potential investors in various locations leading up to a debt offering.

## Secondary market

a market for the resale of already issued and outstanding debt securities.

## Secured debt

a form of debt against the assets of the borrower that can be seized by the holder in the event of default.

## Security (interest)

legal right that is granted by a debtor's collateral that allows the lender to have recourse in the eventuality of default.

## Sinking fund

money set aside in a fund held by a third party to pay off bonds at maturity.

## Sovereign Asset and Liability Management (SALM) Framework

a framework that allows governments to examine all of the accumulated assets and liabilities that the government controls.

## Sovereign/Direct guarantee

a type of guarantee provided by the government to discharge the liability of a third party in case they default on their obligations.

## Special Purpose Vehicle (SPV)

a legal entity created for a limited and specific purpose, typically to raise financing.

## State-owned enterprise (SOE)

a legal entity wholly or partially owned by a government to participate in specific commercial activities on behalf of the government.

## Syndicated loan

loan issued by a syndicate of lenders acting as a group with common terms and represented by an agent.

# Resources and Tools for Effective Debt Management

The following are some resources and tools currently available to government officials responsible for performing debt management functions:

1. Debt Management Information Systems (recording and maintaining debt data).
2. Debt Sustainability Framework for low-income countries (LICs) (analytical functions).
3. Debt sustainability analysis for market access countries (analytical functions).
4. Medium-Term Debt Management Strategy (MTDS) toolkit (analytical functions).
5. Sovereign Asset and Liability Management (SALM) framework (analytical functions).
6. Debt Management Performance Assessment (DeMPA) (strengthening debt management).
7. Fiscal Risks toolkit.
8. Falls Risk Assessment toolkit.

## Debt Management Information Systems

A Debt Management Information System (DMIS) is essential to ensure effective debt management. Debt management offices must be well-equipped with a functional DMIS due to the growing complexities of the sovereign debt portfolio. Accordingly, a good DMIS must, among other things, support comprehensive debt recording, reporting and analysis, enhance data security and reduce processing times, thereby making DMOs more efficient.

The Commonwealth Meridian (Meridian), developed by the Commonwealth Secretariat and UNCTAD's Debt Management and Financial Analysis System (DMFAS) are the two main debt management information systems that assist countries in recording and managing debt by providing a comprehensive repository for external and domestic debt data, both public and private, on an instrument-by-instrument basis, as well as tools to analyse and manage the loan portfolios. Both systems are regularly enhanced to reflect changes in instruments, creditor practices, debt reporting standards and technology in order to represent best practices in debt management.[1]

## Debt Sustainability Framework for Low-Income Countries (LIC-DSF)

The IMF and the World Bank have developed a framework to help guide countries and donors in mobilising the financing of LICs' development needs while reducing the chances of an excessive build-up of debt in the future. Since its inception in 2005, the Debt Sustainability Framework (DSF) has become the most popular tool for analysing debt sustainability in LICs, however, other econometric tools exist as well. Under the DSF, debt sustainability analyses (DSAs) must be conducted regularly.

A DSA consists of: (a) an analysis of a country's projected debt burden over the next 10 years and its vulnerability to economic and policy shocks — which is calculated using baseline assumptions and stress tests; (b) an assessment of the risk of external and overall debt distress, based on indicative debt burden thresholds and benchmarks, respectively, that depend on the country's macroeconomic framework and other country-specific information.

The assessments are performed through standardised templates and are conducted in the context of both IMF financing and Article IV surveillance. Furthermore, DSAs are used to determine a country's access to IMF financing, as well as for the design of debt limits in IMF-supported programmes, while the World Bank uses it to determine the share of grants and loans in its assistance to each LIC and to design non-concessional borrowing limits.

## Debt Sustainability Analysis for Market Access Countries

The IMF has also developed a separate debt sustainability analysis tool for market-access countries (MACs) that typically have significant access to international capital. It involves probabilistic judgments about the trajectory of debt and the availability of financing on favourable terms.

## Medium-Term Debt Management Strategy Toolkit

The MTDS toolkit developed by the World Bank and the IMF provides a spreadsheet-based analytical tool designed to assist country authorities in analysing the cost and risk trade-offs inherent in a government's financing choices. The framework seeks to help countries in the development of a DMS that (a) incorporates key linkages with macroeconomic policy; (b) is consistent with maintaining debt sustainability; and (c) facilitates domestic debt market development.

## Sovereign Asset and Liability Management Framework

The SALM framework allows governments to examine all of the accumulated assets and liabilities that the government controls. It uses fiscal stress tests to gauge the resilience of public finances against shocks and can reveal vulnerabilities that standard debt management analysis might miss. This is because it extends the scope of fiscal analysis beyond the standard measures of debt to include all assets, whether financial, infrastructure or natural resources, as well as liabilities that are rarely included in government debt, such as pension obligations to public sector employees. Although data quality can be an issue, especially when looking at the broader public sector, a SALM framework can be useful even in a very constrained data environment.

## Debt Management Performance Assessment

The World Bank has developed a programme, in collaboration with other partners, to assist developing countries in improving debt management. A key element of the programme is the DeMPA tool, a methodology for assessing sovereign debt management performance through a comprehensive set of performance indicators spanning the full range of government debt management functions. The indicator set is intended to reflect an internationally recognised standard in the government debt management field and may be applied in all developing countries. Nonetheless, the country's context needs to be taken into account when evaluating a country's debt management capacity and needs.

## Fiscal Risk Toolkit

The IMF's Fiscal Risk Toolkit comprises a suite of analytical tools to guide government policy and capacity development. The tools aim to provide a practical basis for countries, at different levels of capacity, to identify, analyse, manage and disclose different sources of fiscal risks. The tools are regularly updated as revisions are made.

# Further Reading

## The ALSF Debt Guides Series

Debt for Nature and Climate Swaps (*African Legal Support Facility and Baker McKenzie*).

Development and Sustainability-Focused Financing (*African Legal Support Facility and Clifford Chance*).

Fiscal Policy and Management (*African Legal Support Facility and Potomac Group*).

Key Consideration for Incurring Non-Traditional Debt (*African Legal Support Facility and Yannis Manuelides at Allen & Overy LLP*).

Governance and Transparency (*African Legal Support Facility and Pari Passau Consulting Ltd.*).

Pre-crisis and Crisis Management (*African Legal Support Facility and White & Case*).

State-Contingent Debt Instruments (*African Legal Support Facility and Cleary Gottlieb*).

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