

Issues Presented by the Côte d'Ivoire Debt Restructurings

Although the Cote d'Ivoire successfully restructured its foreign currency Brady bonds in a bond exchange that closed in mid-April of this year, the ultimate resolution of the country's debt problems has been complicated by the lack of consensus regarding the treatment of its defaulted local currency debt held by foreign investors.

Although it was generally accepted that the Brady bonds would be restructured in line with the principle of comparable treatment with Paris Club debt (see below), at issue is whether certain local currency debt held by foreign investors should also be restructured on similar terms, and if so, on what basis.

While this situation may be too fact-specific to be relevant in future sovereign restructurings, it is worth highlighting the issues presented by this unique set of circumstances because they arise in the context of increasing foreign participation in local bond markets, a trend that is generally perceived to be quite positive.

Since the Asian financial crises of 1997/98, policymakers and academics have been arguing that developing countries should limit borrowing in external currencies and instead, to the extent possible, raise funds in their own local currency.¹ Some participation of non-resident investors is needed to promote this goal, and EMTA members have often been at the forefront of "pioneer investing" into local markets.² The treatment of non-resident holders of local currency debt, which may be determined by the outcome of these debt restructurings, could affect foreign investor appetite for investing in local assets.

Background

Pursuant to the Paris Club Agreed Minutes dated May 15, 2009³ (the "May 15 Agreed Minutes"), the Republic of Côte d'Ivoire committed to seek comparable treatment from all "external creditors" not participating in the Paris Club agreement in

¹ See, *Local Currency Bond Markets*, by John D. Burger and Francis E. Warnock, *IMF Staff Papers, Vol 53, Special Issue, 2006*, pp. 133-146, which argues that emerging economies are not inherently dependent on foreign currency debt, and improvements in local bond markets, and in particular issues such as creditors rights and the rule of law, can result in countries being able to borrow (either domestically or internationally) in their own currencies to greater degrees.

² In November 2007, EMTA hosted a forum between public sector and private sector investors to focus on "Financing African Development Post-HIPC: What Role for the Private Sector?" During that encounter, participating representatives of the public and private sector generally agreed that the best way to promote sustainable financing for the countries of Sub-Saharan Africa is to promote development of local bond markets, including promoting foreign investor participation in those markets. A number of recommendations were made to further this goal, including the suggestion that Sub-Saharan African sovereigns consider issuing local-currency instruments through Euroclear in order to promote foreign investor interest in these assets (for example, by addressing factors hampering foreign participation in the local markets such as poor custodial arrangements.) See, "EMTA Africa Report: Financing African Development Post-HIPC: What Role for the Private Sector?" April 18, 2008, p. 22. (<http://www.emta.org/WorkArea/linkit.aspx?LinkIdentifier=id&ItemID=2838>).

EMTA is also currently involved in a joint initiative with the IBRD to promote efficient development of local markets in Sub-Saharan Africa in order to attract more sustained foreign investment to promote development and economic growth in these markets.

³ See, <http://www.clubdeparis.org/sections/traitements/cote-d-ivoire-20090515/viewLanguage/en>.

all additional debt restructurings.⁴ “External commercial creditors” identified for this purpose included holders of Brady bonds, as well as the holders of two other categories of its defaulted debt – the BNI and Sphynx debt.⁵

The 1998 Brady bonds were denominated in USD and FRF, governed by New York law and originally issued and distributed exclusively to non-residents. Interest arrears began accumulating on these bonds in 2000. In 2009 Côte d’Ivoire and its Brady bondholders (under the auspices of the Private Creditors Coordination Committee (London Club)) agreed to restructure the Brady bonds. The restructuring of the Brady bonds was completed on April 16, 2010, and commercial creditors ultimately provided a level of debt relief beyond what was expected under the Paris Club comparability-of-treatment provision.⁶

⁴ The Paris Club routinely includes the following “Comparability of treatment provision” in its debt treatment proposals, including for the Cote d’Ivoire:

“The Republic of Côte d’Ivoire was declared eligible for the Enhanced HIPC initiative by the IDA and the IMF in December 2008 and was declared to have reached its Decision Point in March 2009. In this context, the Republic of Côte d’Ivoire commits to seek promptly from all its external creditors which are not participating in the Agreed Minutes dated 15 May 2009 (emphasis added), their appropriate contribution in terms of debt relief to the Enhanced HIPC initiative, on top of traditional debt relief mechanisms and consistent with the proportional burden sharing based on their relative exposure in net present value of total external debt at Decision Point after the full use of traditional debt relief mechanisms.

The appropriate nature of the debt relief provided will be assessed not only on the basis of the reduction in the net present value of the debt as computed under Appropriate Market Rate, but also on the terms of repayment of the debts not cancelled. For this purpose, all relevant elements will be taken into account, including the level of cash payments received by those creditors as compared to their share in the Republic of Côte d’Ivoire’s external debt, the nature and characteristics of all treatment applied, including debt buybacks, and all characteristics of the reorganized claims and in particular their repayment terms whatever forms they take and in general the financial relations between the Republic of Côte d’Ivoire and creditor countries not listed in the Agreed Minutes dated 15 May 2009.

Consequently, the Republic of Côte d’Ivoire commits not to accord any category of creditors -and in particular creditor countries not participating in the Agreed Minutes dated 15 May 2009, commercial banks, suppliers and bondholders - a treatment more favourable than that accorded to the Participating Creditor Countries”. (emphasis added) See, May 15 Agreed Minutes.

⁵ In the IMF Cote d’Ivoire Country Report No. 09/326 dated December 2009 (“December 2009 IMF Report”), in its description of “External Debt and Reschedulings”, the BNI and Sphynx debt are included in the types of debt held by “external creditors” and subject to comparable treatment.

“Other external commercial creditors hold three types of instruments (Standard Bank/BNI securitizations, Sphynx 2007–10, and Sphynx 2008–11), each of which are pass-through notes sold to external investors, backed by Ivorian government securities (MEFP ¶19). At end-2008, outstanding debt (including arrears) related to these instruments amounted to about \$290 million, all of which was due to be repaid during 2009–11.

Following previous agreements on rescheduling arrears and outstanding amounts over 2009–11, arrears again began accruing early in 2009 and debt service ceased on all three of these instruments. Recently, the authorities publicly announced their intention to seek to restructure these notes on terms consistent with the Paris Club’s comparability of treatment requirements and with HIPC requirements. The government has engaged financial and legal advisors to assist them in negotiations with creditors.” December 2009 IMF Report, p. 14.

⁶ Keeping in mind that NPV calculations for different instruments can be difficult, at the date hereof, it is generally understood that as a result of the 1998 rescheduling, commercial creditors had already provided their expected debt relief for Côte d’Ivoire (amounting to approximately NPV U.S.\$1 billion (representing a haircut of approximately 74%)). See, Standard Bank Research Strategy Report on Côte D’Ivoire dated March 31, 2006 and <http://www.imf.org/external/pubs/ft/scr/2009/cr09190.pdf>. Commercial creditors then provided an additional approximately 20% debt relief in the recent exchange, which is thought to have exceeded commercial debt relief expectations.

The 2007 and 2008 BNI debt is denominated in XOF and governed by the laws of the Côte d'Ivoire. It was originally consolidated in 2005 and held by a local bank (BNI), then securitized in 2006. Portions of the domestic securities were acquired by Standard Bank PLC (London) and distributed mainly to non-resident investors in 2007 and 2008. Payments on this debt (about XOF 70 billion) were suspended in the second quarter of 2009. The Côte d'Ivoire is now seeking comparable treatment with Paris Club creditors in the rescheduling of this debt.

The Sphynx debt is also denominated in XOF and governed by local law, and was issued in two parts. The 2007/10 Sphynx debt was arranged by Iroko Securities and placed with non-resident investors via Sphynx. The 2008/11 Sphynx debt was placed initially with Côte d'Ivoire-resident Ecobank, which then onsold it to Sphynx via Iroko Securities. This debt has not been restructured, and arrears have been accumulating since 2009. The Côte d'Ivoire is also seeking comparable treatment from Sphynx creditors.

The BNI and Sphynx creditors have been classified as external commercial creditors (see footnote 5), and the debt at issue considered external debt, despite the fact that it is denominated in local currency, and subject to local law, because the creditors are non-residents.⁷

The fact that Côte d'Ivoire is seeking comparable treatment of the BNI and Sphynx debt appears to be the first time that a country has sought comparable treatment from non-resident creditors holding debt denominated in local currency and governed by local law.⁸ This new precedent for determining what is subject to

⁷ There is no consensus on the definition of external debt. The IMF and World Bank policy definition of external debt is defined on the basis of residency. This definition of external debt set out in point 9 of the "Guidelines on Performance Criteria with Respect to External Debt in Fund Arrangements," (IMF Executive Board Decision No. 12274-00/85 dated August 24, 2000) is "based upon the notion that if a resident has a current liability to a non-resident that requires payments of principal and/or interest in the future, this liability represents a future claim on the resources of the economy of the resident and is therefore external debt of that economy." (See, External Debt Statistics, Guide for Compilers and Users, June 25, 2003, IMF).

However, our brief review of how the term "external debt" or "external indebtedness" is defined and used by international market participants shows that these terms have no consistent application in law.

For example, in contrast to the IMF residency-based definition, typically, legal definitions included in bond prospectuses have leaned towards the currency-based definition (including the definition found in the Côte d'Ivoire Brady bond documentation), although loan agreements may include a residency requirement as well. (See generally, Lee Buchheit, "How to Negotiate the Definition of Indebtedness" (IFLR, December 1993); How to Negotiate Eurocurrency Loan Agreements, Second Edition, Euromoney International Investor 2006).

Governing law and place of payment may also be relevant for determining whether debt is external debt. For example, Eurobonds issued by certain countries (e.g., Brazil, Colombia and Egypt) that are denominated in or linked to local currency, may be considered external debt for purposes of triggering Negative Pledge and Cross Default clauses with other hard currency debt. Likewise, many countries have issued securities locally, which are either denominated or linked to foreign currencies (e.g., Tesobonos in Mexico or MinFins in Russia). More research to examine the various risks (credit, currency, legal, convertibility) associated with various types of instruments may be useful.

In general, there is no common understanding of what definition, or set of principles, determines external debt.

⁸ For example, when Cameroon, another HIPC country, completed a debt restructuring with private creditors in 2006, domestic currency debt held by non-residents (but a smaller amount), was not subject to comparable treatment with Paris Club creditors. The commercial debt was in arrears while Cameroon was negotiating its HIPC status. Cameroon cleared its arrears with a cash payment prior to Cameroon's May 2006 Decision Point, and the issue of comparable treatment with Paris Club and London Club creditors did not arise.

comparable treatment (if in fact it can be considered a precedent) seems particularly significant because it includes private commercial claims held by non-residents that have assumed a package of currency, convertibility, liquidity and legal risk typical of local market debt.

Market participants have questioned whether this is logical or defensible on the basis of sound policy and are concerned that it is likely to discourage foreign investors from participating in local markets.

The Evolution of the Principle of Comparable Treatment

In 2000, the official sector's policy of requiring sovereign debtors benefiting from Paris Club debt relief to seek comparable treatment from private creditors⁹ was in effect extended, without much dialogue or consultation with the private sector, from bank credits to include bonds. This broadening of the principle to require bondholders to accept comparable treatment resulted from increasing official sector concerns after the mid-1990's about private sector "burden-sharing" (termed "burden-shifting" by some in the private sector at the time) and from the replacement of bank credits by bonds as the predominant source of financing from the private sector for many debtor countries following implementation of the Brady plan.¹⁰

Despite broad criticism of the fairness and logic of applying the principle of comparable treatment to commercial debts generally,¹¹ over the years, as a practical matter, there has nevertheless been widespread tacit (though in some cases, reluctant) acceptance of the principle of comparable treatment by international capital market participants, when applied to commercial debts (bonds and loans) meeting certain criteria; namely that the debt in question is foreign currency debt, issued in the international capital markets and governed by the laws of New York or England. Moreover, in the case of bank loans and Eurobonds, there has been some expectation that comparable restructuring terms would be negotiated under the auspices of a London Club creditors committee (at the same time there has been a

⁹ See *supra*, footnote 4.

¹⁰ "Up until [2000], the only private-sector lenders that this comparability-of-treatment clause applied to were banks, since the countries coming to the Paris Club for debt restructuring had no bond debt. Furthermore, since the objective was to promote this type of borrowing, there was no question of jeopardizing the growth of bond financing by even hinting that there was a threat of its being involved in future debt restructuring deals.

This exceptional situation, in which bond debt was considered to be under the de minimis threshold, no longer prevails, since bond financing has become a major source of funding. In addition to the unequal burden sharing it entails, the raising of increasingly massive "financial packages" has made this solution unsustainable, particularly for the IMF, which was not intended to provide such packages and which does not have unlimited resources." See, Banque de France Bulletin Digest. No. 86, 2001, p. 41. (<http://www.banque-france.fr/qb/publications/telechar/bulletin/86etud1.pdf>).

¹¹ See "EMTA Submission in Response to HMT – Ensuring Effective Debt Relief for Poor Countries: A Consultation on Legislation" ("EMTA HMT Submission"), p. 20, in which we argue that enshrining the principle of comparable treatment into law (as the proposed legislation would have effectively done) "would be unfair to commercial creditors, which extend credit to sovereigns exclusively on commercial terms for commercial reasons (with the expectation that these loans are governed by regimes of commercial and contract laws with an established framework of sovereign immunity), in contrast to the multifaceted motivations behind official lending (and therefore correspondingly complex and legitimately non-commercial motivations behind official debt forgiveness), which include objectives such as spurring domestic exports, attaining diplomatic goals, furthering humanitarian concerns, and so forth." (<http://www.emta.org/template.aspx?id=5023>).

trend toward the restructuring of bonds following a consultation process short of a formal negotiation).

This criteria for determining what type of debt (rather than what type of creditor) is subject to comparable treatment is consistent with the main characteristics of Paris Club official debt.¹² And, focusing on foreign currency, rather than domestic currency liabilities (to the extent that this how comparability-of-treatment has been applied to date), is also consistent with the carve-out in Paris Club debt treatments that permits official lenders to swap some of their foreign currency debts into local currency liabilities, thus presumably removing those debts from the agreed debt relief parameters.¹³

Accordingly, the extension of the comparable treatment principle to cover local liabilities, solely because they are held by non-residents (if that is indeed how this context is to be interpreted), seems anomalous.¹⁴

Should Comparable Treatment Extend to Local Liabilities Held by Non-Residents?

There are distinct differences in the risks assumed by investors of foreign currency, NY/English law debts, and local liabilities. There are also substantial benefits to the sovereign when a foreign investor provides local financing and supports development of its local market. Therefore, the question that has been asked by market participants is whether it makes sense, as a matter of logic and policy, to subject local currency (and local law-governed) investments by foreign investors to comparable treatment solely on the basis of the residency of the holder?

As a practical matter, foreign investors who limit their exposure to credit risk by purchasing hard currency credits that are governed by NY or English law knowingly accept the risk of payment default and subsequent restructuring, which may involve the application of comparable treatment. As a general matter, such risks are accepted in the context of the greater liquidity associated with hard currency credits (particularly in the form of bonds) and well-established legal norms that generally provide for their contractual enforceability, subject to the limitations of applicable sovereign immunity regimes (particularly in regard to collectability).

Foreign investors who extend credits to a sovereign in the sovereign's own currency assume an additional set of risks - not just credit risk – but convertibility and

¹² Paris Club official lenders are obviously non-residents, the official loans have traditionally been foreign currency-denominated, and the loans presumably subject to agreements governed by the laws of the lender's country.

¹³ The "Possibility to conduct debt swaps" provision, that is routinely included in Paris Club debt treatments, including for the Cote d'Ivoire, states, "On a voluntary and bilateral basis, the Government of each participating creditor country or its appropriate institutions may sell or exchange, in the framework of debt for nature, debt for aid, debt for equity swaps or other local currency debt swaps (emphasis added):

(i) *the amounts of outstanding loans as regards ODA loans;*

(ii) *the amounts of other outstanding credits, loans and consolidations, up to 20% of the amounts of outstanding credits as of 30 September 1991 or up to an amount of 30 million SDR, whichever is higher.*" (See, May 15 Agreed Minutes cited supra, footnote 3.)

¹⁴ Moreover, applicable clearing systems, record vs beneficial ownership and trading in the secondary market may further complicate applying comparable treatment on this basis.

devaluation risk, as well as lesser liquidity in many local markets.¹⁵ Moreover, when foreign investors hold debt instruments that are governed by local law, they generally accept that they have forfeited the same degree of enforceability that comes with an instrument governed by NY or English law for the possibility that the enforceability of the instrument under local law may be changed by the sovereign.

Of course, foreign investors expect to be compensated for these additional risks in the form of higher yields. But it is not clear that foreign investors also expect that, solely because of their residency, their local currency investments are potentially additionally subject to a restructuring required by the principle of comparable treatment with assets having very different characteristics.

As a general matter, the majority of commercial creditors have shown wide acceptance of the need to support debt relief initiatives.¹⁶ In the event debt relief is requested as a result of credit difficulties, foreign holders of domestic currency debt (like foreign holders of foreign currency debt) understand that they will be required to make concessions commensurate with the risks assumed. However, market participants may begin to question the case for their participation in local markets if they will be subject to separate (and inferior) treatment compared to local investors solely by virtue of their residence. This treatment seems counterproductive in that these foreign investors are often pioneering market development and expansion and reducing financing costs and/or extending maturity profiles. In doing so, these investors assume additional devaluation and convertibility risks that do not apply to local investors, nor to foreign lenders of 'hard currency', and thus may be subject to lower effective returns than local investors.

If foreign investors must bear these risks, and also the risk of being subject to comparable treatment, the combined risks will tend, at least at the margin, to inhibit the participation of foreign investors, to the detriment of these local markets and the ability of sovereign debtors to raise financing while limiting their foreign currency risks, or result in increased financing costs.

As a general matter, this is not a desirable outcome for EMTA members or developing countries, and surely is an unintended consequence of the proposed treatment of the BNI/Sphynx debt that deserves further review and discussion.

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¹⁵ A classic example of the realization of these risks can be seen in Russia's 1998 debt default. The Russian rouble was maintained in a tight range from 1995 through to the 1998 default. Almost overnight the currency plummeted from RUR 6.2/USD1 at the time of the August 1998 default to around 16:1 and then over 20:1 by the year-end, by which time M2 had increased by 25% since the default to circa RUR 460 billion. This swingeing move was mirrored in the trading yield of local treasury bills (GKOs) which rose from the mid-teens in late 1997 to 60-70%pa in summer 2008 before reaching three-figures prior to the suspension of the market. Such catastrophic moves inevitably resulted in the failure of most hedges and big losses for foreign investors as Russian banks largely defaulted on their forward rouble contracts, which were subsequently settled at rates imposed by the government.

¹⁶ See, EMTA HMT Submission, *supra*, footnote 11, pp. 4-8.