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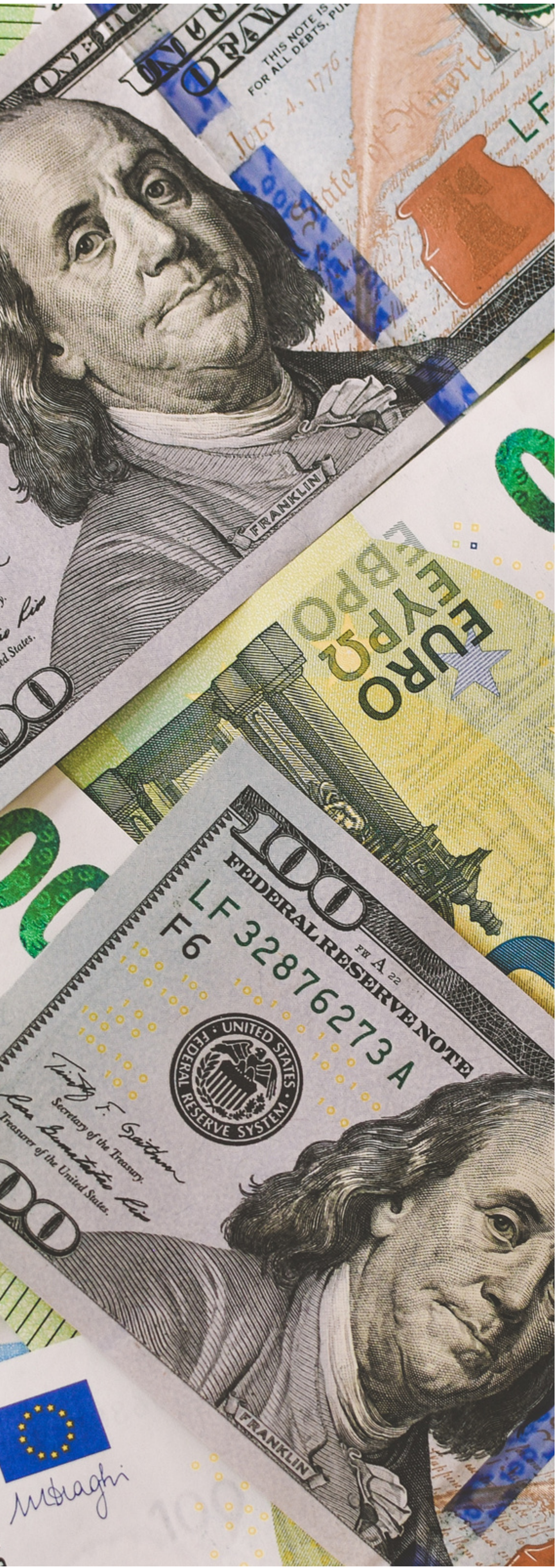

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A Proposal for a New Approach to Restructuring African Eurobonds: The DOVE Fund and Principles

By Daniel Bradlow

This article argues that the current arrangements for restructuring sovereign bonds do not meet Africa's needs. African states and their supporters should create a DOVE (Debts of Vulnerable Economies) Fund that can purchase the bonds of African sovereign debtors in distress and commit to restructure them in accordance with the DOVE Fund Principles. This Fund can help interrupt inter-creditor dynamics and push the bondholders to be more open to innovative approaches to debt restructuring. This article, after briefly considering some of the problems with the current process for restructuring sovereign bonds, discusses the DOVE Fund and the DOVE Fund Principles.

Le présent article soutient que les dispositions actuelles en matière de restructuration des obligations souveraines ne répondent pas aux besoins de l'Afrique. Les États africains et leurs partisans doivent envisager la création d'un Fonds de restructuration des dettes des économies vulnérables (DOVE selon son acronyme anglais) qui pourrait acquérir les obligations des débiteurs souverains africains en difficulté et s'engager à les restructurer dans le respect des principes définis par le Fonds. Ce Fonds peut contribuer à faire cesser les arrangements entre créanciers et pousser les détenteurs d'obligations à être plus ouverts à des approches innovantes en matière de restructuration de la dette. Après une brève analyse des problèmes liés au processus actuel de restructuration des obligations souveraines, l'article se propose d'expliquer en quoi consiste un Fonds DOVE et quels sont les principes qui le régissent.

Este artículo sostiene que los acuerdos actuales para la reestructuración de los bonos soberanos no satisfacen las necesidades de África. Los Estados africanos y sus partidarios deberían crear un Fondo DOVE (Deudas de Economías Vulnerables) que pueda comprar los bonos de los deudores soberanos africanos en dificultades y comprometerse a reestructurarlos de acuerdo con los Principios del Fondo DOVE. Este Fondo puede ayudar a frenar la dinámica entre acreedores y empujar a los tenedores de bonos a estar más abiertos a enfoques innovadores para la reestructuración de la deuda. Este artículo, tras considerar brevemente algunos de los problemas del actual proceso de reestructuración de bonos soberanos, analiza el Fondo DOVE y los Principios del Fondo DOVE.

Africa is facing a potentially serious sovereign debt problem. Currently, 22 low-income African countries[1] are either in debt distress or at high risk of debt distress. Given the difficult international environment, this number may grow.

A particularly challenging part of Africa's debt is likely to be the Eurobonds that 21 countries had issued by 2020[2], the latest year for which figures are available. These bonds accounted for about 20% —$136,5 billion —of Africa's total external debt stock of $702,4 billion in 2020. They are also expensive. For example, on 31 August 2022, they were trading at an average yield of over 12%, which is about 9% over yields on United States Treasuries. By comparison, the interest rate on World Bank loans is currently around 2% for International Bank for Reconstruction and Development (IBRD) borrowing countries and under 1% for International Development Association (IDA)-eligible countries.

The current arrangements for restructuring sovereign bonds are complex, inefficient, and time-consuming. They also do not meet Africa's needs. However, African states cannot afford to either depend on the kindness of their creditors or wait for substantial improvements in these arrangements to become politically feasible. Instead, they need to take action on their own to improve the outcomes of the restructuring of their debts.

African states and their supporters can do this by disrupting inter-creditor dynamics and pushing their bondholders to be more open to innovative approaches to debt restructuring. Their supporters should create a Debts of Vulnerable Economies (DOVE) Fund[3] that can purchase the bonds of African sovereign debtors in distress and commit to restructuring them in accordance with the DOVE Fund Principles.

[1] International Monetary Fund, "List of LIC DSAs for PRGT-Eligible Countries as of September 30, 2022". Available from https://www.imf.org/external/Pubs/ft/dsa/DSAlist.pdf.
[2] Gregory Smith, "Africa's Hard-Won Market Access", International Monetary Fund, December 2021. Available from https://www.imf.org/en/Publications/fandd/issues/2021/12/Africa-Hard-won-market-access#:~:text=Entering%20the%20debt%20market,issued%20in%20global%20financial%20centres.
[3] Daniel D. Bradlow, "Deterring the Debt Vultures in Africa", Project Syndicate, 20 May 2020. Available from https://www.project-syndicate.org/commentary/new-fund-can-deter-africa-sovereign-debt-vultures-by-daniel-d-bradlow-2020-05.

After briefly considering some of the problems with the current process for restructuring sovereign bonds, this article will discuss the DOVE Fund and the DOVE Fund Principles.

The Current Sovereign Bond Restructuring Process

The parties to sovereign bond restructurings face a number of challenges. First, there is no legally binding mechanism or forum for restructuring the bonds issued by a sovereign debtor that are denominated in foreign currencies and are governed by foreign law. As a result, sovereigns and their bondholders use voluntary processes in which at least a critical mass of creditors are willing to participate. The second challenge is the logistical and technical problems created by the relatively large number of bondholders, most of whom have their own mandates, risk tolerances, and fiduciary responsibilities. Third, neither financial markets nor bond contracts incentivize the bondholders to provide adequate relief to sovereign debtors in distress. Fourth, while there are analytical tools, precedents, contractual terms, and market customs that the parties can utilize in the debt restructuring process, there is no universally accepted international norm or standard that they can use to fairly allocate the burdens, risks, and rewards of the restructuring.

The DOVE Fund

The proposed DOVE Fund would be an investment fund established and financed by the stakeholders in African debt to invest in marketable foreign currency denominated debt issued by African countries in debt distress or debt default. Therefore, potential investors in the DOVE Fund include the financial and non-financial firms that do business with the debtor country, philanthropic foundations, international and national civil society organizations, multilateral organizations and donor governments that provide the country with financing and/or technical support, and individuals.

The Fund would be authorized to buy the bonds of sovereign debtors in distress and to only agree to debt restructurings that comply with the DOVE Fund Principles. These Principles promote a debt restructuring process that is transparent and fair to all stakeholders and results in an agreement that supports economically, financially, socially and environmentally sustainable and inclusive development in the debtor country.

Since the Fund would be a participant in international financial markets, it must offer its investors the possibility of earning a return on their investment. This is feasible because the DOVE Fund, as a bondholder, will receive whatever interest and principal payments may be due on its investment in the financing instruments used in any restructuring.

The DOVE Fund Principles

The DOVE Fund Principles serve three purposes. First, the parties directly involved in a sovereign debt restructuring can use them to guide their decisions and actions in the debt restructuring. Second, the Principles can be used as a benchmark against which stakeholders can assess the outcome of the debt restructuring. Third, the Principles can be used by any investment fund, such as the DOVE Fund, to define the approach it will take in sovereign debt restructurings.

The DOVE Fund Principles are based on norms and standards developed by international organizations, industry associations, and civil society organizations over the past two decades. Some of these norms and standards exert a compliance pull on at least some of the parties involved in sovereign debt restructurings because of the credibility of their sponsoring entities and the process followed in developing them. Others are recognized by many of the stakeholders in sovereign debt transactions as addressing issues relevant to sovereign debt restructurings. Consequently, most international investors support at least some of these international standards.

While these norms and standards share some common elements, they also have significant differences. This is not surprising. Some of them were developed with a strong pro-creditor bias, some have a strong pro-sovereign debtor bias, and some seek to be more neutral and technical.

The main international norms and standards consulted in developing the DOVE Fund Principles are:

- African Forum and Network on Debt and Development (Afrodad) Fair and Orderly Framework for Sovereign Debt Restructuring
- Afrodad Harare Principles
- Climate Fund Managers Responsible Investment Policy
- European Network on Debt and Development (Eurodad) 10 Civil Society Principles for Sovereign Debt Resolution
- International Capital Market Association (ICMA) Guiding Principles for Green Bonds
- ICMA Guiding Principles for Social Bonds
- ICMA Guiding Principles for Sustainability Linked Bonds
- Institute of International Finance (IIF) Principles for Stable Capital Flows and Fair Debt Restructuring
- IIF Voluntary Principles for Debt Transparency
- Organisation for Economic Co-operation and Development (OECD) Due Diligence for Responsible Business Practices
- Principles for Responsible Development (PRI) Environmental, Social, and Governance (ESG) Engagement for Sovereign Debt Investors
- PRI Why and How Investors Should Act on Human Rights
- United Nations Conference on Trade and Development (UNCTAD) Principles on Responsible Sovereign Lending and Borrowing
- UNCTAD Debt Workout: Going Forward Roadmap and Guide
- United Nations General Assembly (UNGA) Basic Principles on Sovereign Debt Restructuring Processes
- United Nations (UN) Guiding Principles on Business and Human Rights
- UN Office of the High Commissioner for Human Rights (OHCHR) Guiding Principles on Foreign Debt and Human Rights
- UN OHCHR Guiding Principles on Human Rights Impact Assessments and Economic Reforms
- World Bank and other multilateral development banks Environmental and Social Frameworks
- World Bank Debt Transparency in Developing Countries Report

The DOVE Fund Principles

<u>Principle 1: *Guiding Norms:*</u> Sovereign debt restructurings should be guided by the following 6 norms: Credibility, Responsibility, Good Faith, Optimality, Inclusiveness, and Effectiveness.

- *Credibility* means that the Negotiating Parties and the Affected Parties are confident that the restructuring process can produce an outcome that optimally restructures the sovereign's debts. The "Negotiating Parties" are the sovereign debtor and its advisors and those creditors and their representatives with whom it is negotiating the terms of the debt restructuring. The "Affected Parties" on the debtor side are the residents of the debtor country who will experience the impacts of the debt restructuring and the individuals and organizations they may choose to represent them. On the creditor side, they are those individuals whose savings are being used directly or indirectly to purchase the restructured bonds and their representatives.
- *Responsibility* means that the Negotiating Parties will seek a restructuring agreement that respects their respective economic, financial, environmental, social, human rights, and governance obligations and/or responsibilities.
- *Good Faith* means that the Negotiating Parties have the clear intent to reach an agreement that takes appropriate account of the rights, obligations, and responsibilities of the Negotiating Parties.
- *Optimality* means that the Negotiating Parties should aim to achieve an Optimal Outcome—an outcome that, taking into account the circumstances in which the parties are negotiating and their respective rights, obligations, and responsibilities, offers each of them the best possible mix of economic, financial, environmental, social, human rights and governance benefits.
- *Inclusiveness* means, first, that all creditors should have the opportunity to participate in the restructuring process and that the debtor should provide them with timely access to the information they need to make informed decisions about their participation in the process and its implications for them. Second, while the Negotiating Parties are the decision-makers in the restructuring process, they should offer the Affected Parties timely access to sufficient information to make informed decisions about how the restructuring will impact them.
- *Effectiveness* means that the Negotiating Parties should seek to reach an Optimal Outcome in a timely and efficient manner.

<u>Principle 2: *Transparency:*</u> The sovereign debt restructuring process should afford the Negotiating Parties and the Affected Parties access to the information they need to make informed decisions regarding the debt restructuring.

This Principle requires, first, that the sovereign debtor should provide each group of its creditors with access to sufficient information so that they can make informed decisions about the scope of the sovereign's debt problems, the options for their resolution, and their potential economic, financial, environmental, social, human rights and governance impacts.

Second, the sovereign debtor should make sufficient information publicly available, subject to appropriate safeguards, so that the Affected Parties can understand the gravity of the debtor's current debt situation and can make informed decisions about how the negotiated outcome may affect their rights and interests. This is particularly important because the sovereign debtor has legal obligations to the Affected Parties resident in the debtor state that must be respected and protected in the restructuring process. These commitments arise from the sovereign debtor's domestic legal order and its international legal obligations, including pursuant to international human rights and environmental treaties.

In addition, this Principle requires that the creditors should ensure that the sovereign debtor and the Affected Parties have access to all relevant information on their environmental, social, and human rights obligations and responsibilities. The creditors' obligations may arise from their home country's laws. Their responsibilities may arise from their own policies and the voluntary trade and international standards they have signed. While these responsibilities may not be legally binding, it should be assumed that the creditors accepted them in good faith and with the intent to comply with them in all their activities, including in sovereign debt restructurings.

Principle 3: *Due Diligence:* The sovereign debtor and its creditors should each undertake appropriate due diligence before concluding a sovereign debt restructuring process.

This Principle requires the Negotiating Parties to utilize a debt sustainability analysis which they all view as credible to determine the scope of the sovereign's debt problems. They should also ascertain that they have identified all the Affected Parties and have sufficient information to understand the scope and the depth of each category of Affected Party's interest in the restructuring.

Principle 4: *Optimal Outcome Assessment:* At the earliest feasible moment, the Negotiating Parties should publicly disclose why they expect their restructuring agreement to result in an Optimal Outcome.

Any restructuring agreement will necessarily be based on imperfect knowledge and complex assumptions about the sovereign borrower's future economic, financial, social, environmental, human rights, and governance situation. This fact does not relieve the Negotiating Parties of their responsibility to seek an agreement that, in good faith, they expect to have an Optimal Outcome. In order to maximize the prospects for reaching such an outcome, this Principle encourages the Negotiating Parties, as far as is feasible under the circumstances, to assess the expected impacts of their proposed agreement on the economic, financial, environmental, social, human rights and governance condition of the sovereign borrower and the Affected Parties.

Principle 5: *Monitoring:* The restructuring process should incorporate credible mechanisms for monitoring the implementation of the restructuring agreement.

This Principle requires the Negotiating Parties to identify the mechanisms they will utilize to audit the agreement's financial aspects and monitor its economic, social, environmental, human rights, and governance impacts. The information should also be made publicly available, subject to appropriate protection for confidential information, in regular periodic reports accessible to all Affected Parties.

Principle 6: *Inter-Creditor Comparability:* The restructuring process should ensure that all the sovereign borrower's creditors participate in and make a comparable contribution to the restructuring of its debt.

A credible and sustainable sovereign debt restructuring agreement should give creditors the confidence that the borrower is treating them comparably. It is also desirable that all creditors have sufficient information on the terms and conditions being offered by other creditors so that they can be confident that, in fact, all other creditors are making comparable contributions to the sovereign debtor reaching an Optimal Outcome.

Principle 7: *Fair Burden Sharing:* An Optimal Outcome should share the burden of the restructuring fairly between the Negotiating Parties and should not impose undue costs on any of the Affected Parties.

The complexities of public finance and sovereign borrowing mean that both creditors and debtors enter into their debt transactions with imperfect knowledge about the risks they are assuming. Consequently, it is likely that in many, if not all, sovereign debt crises, both debtor and creditor bear some responsibility for causing the difficult debt situation and should absorb some of the restructuring costs. Moreover, on both sides of the transaction, there are parties who may not have played any role in creating the debt crisis but who will have to bear some of the restructuring costs. On the debtor side, these are the Affected Parties who may lose their jobs, their access to public services and who may face additional hardships because of the restructuring. On the creditor side, these parties may include investors whose pensions and life savings might be adversely affected.

This Principle requires that the adverse impacts of the restructuring and their costs should be shared fairly between all the parties to the restructuring. Their relative wealth and ability to absorb losses will vary, which may be a factor in determining the allocation of burdens in the restructuring.

Principle 8: *Maintaining Market Access:* The restructuring agreement should be designed to facilitate future market access for the borrower to the greatest extent possible.

The United Nations estimates that Africa will need an additional approximately $800 billion per year for at least the next 5 years to deal with climate change, the impacts of COVID, and to build the infrastructure and health systems that the continent needs[4]. It cannot obtain these funds only from its own resources and the available official development sources.

It is, therefore, an unfortunate reality that African countries have no choice but to seek financing from international financial markets. However, the mere fact that a sovereign's debt needs to be restructured is likely to adversely affect its access to financial markets in the short run. Therefore, the Optimal Outcome of any restructuring agreement should also help the debtor regain access to financial markets as quickly as possible.

An Example

Assume that the Republic of Malundi and its bondholders have agreed to discuss the restructuring of Malundi's Eurobonds. They have also agreed that their negotiations will be guided by the DOVE Fund Principles. Assume further that the Malundian government has publicly announced its climate and sustainability priorities for the next 3-5 years.

At the start of the process, pursuant to DOVE Fund Principle 2, dealing with transparency, Malundi will provide the Negotiating Parties with information on its current debt situation and its rationale for entering into restructuring negotiations with the bondholders and its other creditors. It also makes a public statement on its current debt position and the expected impact on its publicly announced climate and sustainability priorities. The bondholders, in turn, will inform the government of Malundi about their environmental, social, governance, and human rights responsibilities and obligations.

Relying on principle 3, dealing with due diligence, the Negotiating Parties agree on the debt sustainability framework they will use in their negotiations. This could be the International Monetary Fund (IMF)'s debt sustainability analysis for Malundi or any other mutually acceptable framework. Malundi assesses how the current debt situation will affect its policy priorities if the parties are not able to reach an agreement. It will also identify all the in-country Affected Parties. The bondholders will assess how the current situation will affect their financial, environmental, social, governance, and human rights responsibilities and obligations. They will also identify their Affected Parties.

Under Principle 4, dealing with the Optimal Outcome, the Negotiating Parties will prepare a statement that explains why they believe the proposed agreement is the Optimal Outcome. This could include an explanation of how this agreement compares to the agreements that Malundi has concluded or plans to conclude with its other creditors. Once their agreement is signed, Malundi will issue a public statement explaining the key terms of the agreement and how the saved funds will be invested to promote its climate and sustainability priorities and the associated risks.

In applying Principle 5, dealing with monitoring, the parties will arrange for a regular financial audit. They will also stipulate who will monitor and report on the environmental, social, human rights, and governance impacts caused by the agreement's implementation. Pursuant to Principle 6 on comparable treatment, Malundi will provide copies of these reports to all creditors. Based on Principle 7, dealing with fair burden sharing, Malundi will also make these reports, subject to appropriate safeguards, available to all Affected Parties.

Pursuant to Principle 8, on ensuring market access for the borrower, the restructuring agreement should offer both the sovereign issuer and the bondholders a better outcome than would be possible without the application of the DOVE Fund Principles. For example, they might show that, without the Principles, the only option available to the bondholders would be a haircut implemented through some combination of an interest rate cut &/or principal reduction &/or lengthened maturity (Option 1). With the DOVE Fund Principles, the bondholders will be able to choose between a Dove Fund compliant bond or Option 1 or a combination of the two. The DOVE Fund compliant bond will offer the sovereign access to more funds than it would get through Option 1 provided the additional funds are

[4] United Nations Economic Commission for Africa, "The Dice is Loaded against Africa: Ministers Call for Reform", 17 May 2022. Available from https://www.uneca.org/stories/the-dice-is-loaded-against-africa-ministers-call-for-reform.

used to advance the government's chosen climate and/or sustainability goals. The additional funds will be made available in a way that is transparent and monitorable, thereby increasing the confidence of the Negotiating and Affected Parties that the funds are being used for their intended purpose. This, in turn, should increase the bondholders' confidence that the sovereign will meet its obligations in a timely manner. They may also be able to profit from any new opportunities that may arise from the sovereign's improved ability to implement and reach its stated climate and sustainability priorities. The DOVE Fund compliant bond could also increase the debtor's incentive to comply by stipulating that if it fails to meet certain targets within specified periods, it will have to pay a premium for a stipulated period and that if it exceeds the targets, it will receive a discount for the stipulated period.

Conclusion

The current arrangements for restructuring sovereign debt do not offer creditors sufficient incentive to incorporate an assessment of social, environmental, human rights and governance impacts, as well as financial considerations, into the sovereign debt restructuring process. The result is sub-optimal for African sovereign debtors and their citizens. They, therefore, need to do something that changes the creditors' calculus of the optimal response to a sovereign debt crisis. The DOVE Fund Principles, by both ensuring fair treatment of all Negotiating and Affected Parties and by helping to identify all the costs and benefits of the transaction, should help change the creditors' calculus of the Optimal Outcome of any sovereign debt restructuring. The DOVE Fund would offer all stakeholders an opportunity to support these changes actively.

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