CABRI Policy Dialogue

Negotiating Fair and Balanced Contracts with Creditors/Investors in Africa, 5–6 October 2021

POST-EVENT REPORT

CABRI hosted its second Policy Dialogue for African public debt managers for the year on negotiating fair and balanced contracts with creditors/investors in Africa on 5 and 6 October 2021.

Some countries have clear negotiation strategies and procedures, while others are less able to bargain effectively and exert influence in negotiations. Poorly negotiated agreements mean that African countries are not getting the best terms and conditions available with agreements often skewed in favour of the creditor/investor. This imbalance can be particularly problematic in times of crisis when restructuring the public debt portfolio becomes unavoidable.

The dialogue was attended by 72 participants, from 26 African countries as well as legal experts, investment banks, creditors, investors, regional representatives, and other relevant stakeholders. The event provided a platform for African debt managers to share their experiences in negotiating with different creditor groups, highlight common pitfalls and identify practical steps through which African governments can improve negotiation outcomes. The four areas of focus were:

- Improving the transparency of sovereign debt negotiations
- Enhancing the government's negotiations position through rigorous financial analysis
- Understanding key legal concepts and room to manoeuvre
- Assessing the options and opportunities for restructuring sovereign debt

This note summarises the **8 key messages** emerging from the Policy Dialogue. All conference materials (videos, presentations and background papers) can be accessed **here**.

Key message 1: Effectively negotiating debt contracts requires a variety of technical skills

Public debt managers are not necessarily lawyers, and lawyers are not necessarily financial experts. As the debt landscape continues to evolve and countries gain access to more complex financing arrangements, it is important that governments hire reputable international legal and financial experts, while at the same time building in-house capacity in these areas. This capacity building will not happen overnight and requires sustained commitment from the highest level of government. Having the rights skills available at the right time increases the likelihood that debt contracts are legally sound, respect domestic and international law and recommended market practices and do not undermine value for money and the affordability of governments' fiscal frameworks.

Key message 2: The negotiation process should be guided by a robust institutional and legal framework

The negotiation of debt contracts often requires the inputs from multiple actors outside the Debt Management Office, such as line ministries/state-owned entities, Parliament, Ministry of Justice, Ministry of Foreign Affairs and Central Bank. **It is important that the negotiation process, and the roles and responsibilities of each stakeholder in the debt cycle are clearly defined (for example, clear stipulated in a debt management procedure manual), well understood, communicated to all, and respected.** This is important since different actors in governments as well as outside government may have different interests, incentives, and ways of to avoid standard or set procedures. The legal framework should also clearly set out the authority to borrow (in both domestic and foreign markets) and issue guarantees and stipulate the rules of engagement, the approval process and the government's debt management objectives.

Key message 3: Transparency and communication

The provision of comprehensive and accurate data on the existing debt stock is critical for making informed borrowing and lending decisions. This information should be provided by governments in a timely and systematic manner, for example, through pre-budget consultations, budget documents, debt reports, investor relations website and through regular interactions/engagements with key stakeholders. The provision of data to inform the negotiation process should not be seen as a once off event but rather a continuous year long process of providing reliable information in a transparent and accessible manner. Also important to communicate any change or adjustments to the annual funding plan well in advance, to avoid any misperceptions.

However, confidentiality clauses in debt contracts can limit the DMO's ability to provide accurate and comprehensive data and are also likely to significantly impede debt restructurings. In cases where a government is seeking to restructure its debt, it is likely to have to request a waiver to these confidentiality clauses, to be able to share information with legal advisors and creditor committees for negotiations to progress. Some creditors also impose hidden fees or ambiguous clauses that make it difficult for government to make informed borrowing decisions.

Another growing threat to debt transparency that needs to be proactively managed by debtor governments relates to the contracting of resource-backed loans by state-owned entities or special purpose vehicles. Despite these loans typically being guaranteed by the central government, DMOs are often excluded from these negotiations, and often do not even have access to the underlying loan agreement. Governments therefore need to strengthen their oversight role of Ministry of Finance, Parliament and DMO in the authorisation of collateralised loans. Government's debt recording and reporting system also need to go beyond the usual capturing of public debt transactions and their financial terms and conditions, and also cover collateral features of debt instruments. The current health and debt crisis and the need to restructure, might be the opportunity for Governments to relook at current practices, to improve on reporting and sharing of information, to make, for example, these collateralised loans public.

Transparency, however, covers both sides of the coin. Concerns were raised that sometimes commercial banks do not disclose all costs or fees, which impedes the government's ability to properly assess the full costs of financing and compare to alternative funding options.

Trust could only be built among creditors and the sovereign borrower in the negotiation process, if informed decisions could be based on adequate information.

Key message 4: Rigorous financial analysis is a critical component of the debt negotiation process

Different sources of financing will have different risks that need to be carefully accessed by governments. When it comes to debt instruments, **it is important that the DMO evaluates the key financial terms before the start of the negotiations process, in preparing themselves to assess the cost effectiveness and to compare with alternative funding options.** Key tools used by DMOs to assess the costs and risks trade-offs of government's borrowing strategy and annual funding plan, are the Debt Sustainability Analysis (DSA); and the Medium-Term Debt Management Strategy (MTDS), to determine the best and prudent financing stream. Borrowing limits should also be guided by the outcome of the DSA and MTDS and will help to discourage unsolicited financial proposals, which still sometimes find a backdoor.

Public debt managers should be aware not only to look at the numbers. The legal wording can change the calculation of a fee.

Finally, the DMO must be prepared to explain and clarify the analysis underling its recommendations to non-technical experts. This requires open communication channels and relationships to policy makers and other key stakeholders to ensure that recommendations are respected and duly considered.

Key message 5: Legal terms and provisions are not set in stone and must be carefully examined and negotiated

All the provisions in a debt contract, even those based on common market practices, are open to negotiation and should not be automatically accepted in the form presented by the creditor without due examination by the legal advisors of the debtor government.

The key objective of the debtor government is to ensure that each clause is drafted in a manner that is operationally workable. To achieve operational workability, the debtor government should ask questions as well as propose the use of certain exceptions and qualifications. A borrower or issuer should also ensure in negotiating covenants (that is, promises to do or not do something during the life of a lending arrangement) that the costs for compliance with the terms are manageable and the covenants will be achievable and not interfere with day-to-day operations.

During this session, legal experts and government officials provided several concrete examples of how certain problematic clauses (for example, Pari Passu, Event of Default and Cross-Default) could be tweaked to better suit the position of the debtor government. Experts emphasised the importance of getting "Definitions" right since they determine the sensitivity of other clauses in the contract. In negotiating the Pari-Passu clause (which ensures equal ranking of unsecured creditors), the borrower or issuer should try to limit the scope of the definition of outstanding debts, distinguish between contractual performance defaults and payment defaults, and distinguish between different types of indebtedness (i.e., between bonds and loans). In negotiating the Event of Default clause, borrowers should make use of grace periods, materiality thresholds, dollar amount thresholds and remove those that are not applicable to sovereigns (e.g., insolvency, audit qualifications). In negotiating cross default/acceleration clause, the Borrower might want to further limit the cross default/acceleration clause to payment terms (and not just any clause).

For further details on key clauses in debt contracts, see the background paper prepared for the Policy Dialogue.

Key message 6: China is not a homogenous entity but is made up of different lending institutions facing different incentive structures

China has emerged as Africa's largest bilateral official creditor and behaves differently compared to other OECD official bilateral creditors in terms of the commercial nature of some of its debt contracts as well as its approach to debt restructuring. This is partly because Chinese lending is fragmented across several different institutions, China's

Ministry of Commerce/CIDCA, China Development Bank (CDB), China Export-Import Bank (China Eximbank), Sinosure, and other commercial lenders.

Debt negotiations with China will vary by the type of loan and the creditor involved. Only zero-interest loans from China's Ministry of Commerce/CIDCA, which come from the foreign aid budget, are likely to receive debt cancellation, while options for debt relief become narrower for more commercial loans.

No commercial bank in China can forgive a loan without the approval of the State Council which constitutes the highest administrative authority in China. However, because bank personnel tend to be personally accountable for the performance and repayment of loans (that is, defaults and financial losses have professional and political repercussions for the banker), they are likely to be opened to rescheduling payments, waiving certain contractual requirements, and extending the drawdown period in order to avoid a default on the principal. What this means is that, even though contracts appear more commercial, there is sometimes more space for flexibility with borrowing partners, compared to private sector creditors.

Finally, while China has agreed to participate in the G20 debt relief initiatives, the Debt Service Suspension Initiative (DSSI) and the Common Framework for Debt Treatments beyond the DSSI, there have been some challenges in operationalising these initiatives. While China has been the largest contributor of debt standstill under the DSSI, it is becoming less reluctant to offer debt treatments given the lack of involvement of other creditors, particularly private sector creditors and multilateral development banks. Certain clauses in China's debt contracts relating to confidentiality and restrictions on debt restructuring may also frustrate the Common Framework process and may require debtor governments to request waivers.

For further details on negotiating with China, see the case study prepared for the Policy Dialogue.

Key message 7: Understand your negotiation power and ways for increasing this power

Various country experiences shared highlighted that although creditors usually enjoy the upper hand, some debtor governments have been more successful than others in influencing negotiation outcomes. **This is partly due to differences in governments' negotiating power.** A borrower's negotiating power/bargaining power is likely to be affected by its credit rating; those with a higher credit rating will have more room to dictate or resist the terms as presented.

The importance of geo-political relationships should also not be underestimated, especially in the context of government-to-government lending. Compared to other lenders, Chinese creditors often offer greater flexibility for borrowers in times of difficulty, due in part to the salience of the bilateral political relationship as well as the abovementioned personal accountability dimension of Chinese bankers.

A government's negotiation power is also not static. The debtor government can improve its relationships with creditors and foster credibility and goodwill by providing creditors with reliable and timely debt data to enable them to make informed decisions as well as providing early notification of potential defaults or repayment difficulties. Lack of transparency is likely to weaken a government's negotiation power, erode trust with its creditors/investors and lead to protracted negotiations.

Key message 8: Governments must not neglect crisis prevention measures

While shocks and other factors beyond the government's direct control may require a government to restructures its debt obligations, **it is also important that governments respect legal contracts they have agreed to and implement ex-ante measure to reduce the risk of debt distress and the need for restructuring.** The three key areas that some governments should prioritise to address structural problems that existed before COVID-19 include developing a process for scrutinising costs and benefits of debt financing, producing reliable debt data to ensure accountability, and establishing the rule of law to fight opportunism and corruption.

In conclusion, as was stated in the opening remarks of the above dialogue:

> In July, as debt managers we considered the vulnerabilities countries are facing with high debt levels, such as roll-over risks, etc. Apart from the vulnerabilities, debt managers are also facing many uncertainties, such as volatile exchange and interest rates, etc. These vulnerabilities and uncertainties, together with the current health and debt crisis, have put enormous strain on the fiscus.

As discussed, it is only through the continuous strengthening of our capabilities, processes, policies and practices that as debt managers we will be able to stabilise matters. Further, by sharing reliable information, in preparing ourselves for the negotiation process, (analysing funding options), understanding the legal implications of loan/bond contracts, that debt managers eventually will become better negotiators and therefore not undermining social outcomes, value for money and the affordability of our fiscal frameworks.

For any comments or other suggestions, please don't hesitate to contact Johan Krynauw, programme manager public debt management at CABRI at Johan.Krynauw@cabri-sbo.org

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