56827

THE WORLD BANK
Washington, D.C. 20433
U.S.A.

BARBER B. CONABLE
President

July 19, 1990

MEMORANDUM TO THE EXECUTIVE DIRECTORS

REVIEW OF IBRD'S NEGATIVE PLEDGE POLICY WITH RESPECT TO DEBT AND DEBT SERVICE REDUCTION OPERATIONS

I. Introduction

1. At the meeting of the Executive Directors on April 10, 1990, which considered the President's Memorandum entitled "Review of Progress under the Program to Support Debt and Debt Service Reduction" (R90-48, dated March 21, 1990), Executive Directors generally supported the Bank's present restrictive practice concerning waivers of its negative pledge clause, but asked Management to provide a paper reviewing the Bank's policy of granting waivers to the Bank's negative pledge clause in respect of debt and debt service reduction (DDSR) operations.

2. This paper examines the Bank's negative pledge policy with a view to assisting Executive Directors in addressing the question of the appropriateness of this policy. Section II gives a brief overview of negative pledge clauses generally and describes the Bank's negative pledge policy as articulated in the negative pledge clause included in the Bank's loan and guarantee agreements with its borrowers. Section III reviews how the Bank's policy has been applied, with a particular emphasis on the Bank's recent practice in DDSR operations in the heavily indebted countries. Section IV summarizes recent developments that may lead to a broader range of requests for waivers and their implications for future application of the policy. Finally, Section V makes certain recommendations for consideration by Executive Directors with respect to the Bank's policy towards DDSR operations in the future.

II. The Negative Pledge Clause

(a) General

3. Negative pledge clauses are concerned with the granting of security interests by a borrower over its assets to its creditors. By the terms of such a clause, the borrower agrees with a creditor or group of creditors to restrictions on its granting, or otherwise permitting to exist, security interests in favor of other creditors. The scope of such restrictions vary a great deal. Some clauses prohibit the creation of any security interest on any of a borrower's assets. More typically, however, clauses prohibit the creation of security interests in favor of other creditors unless equal and rateable security is granted to the creditor to

whom the undertaking is given. While the reason for obtaining such an undertaking varies from creditor to creditor, two objectives usually underlie all such clauses: preventing a situation in which significant assets of the debtor are "allocated" to other creditors, thereby effectively subordinating the unsecured creditors; and inhibiting a debtor from incurring excessive liabilities.

4. The negative pledge clause is not the only legal provision designed to provide protection to the "standing" of a creditor's claim on a debtor in relation to those of other creditors: the pari passu provision and the mandatory prepayment/prohibition of prepayment provisions are also relevant here. Under the pari passu provision, the debtor represents and warrants, or covenants, that the payment obligations of the borrower under the relevant agreement contractually rank at least equal ("pari passu") in priority of payment with all other indebtedness claims on the debtor. The typical mandatory prepayment provision obliges the debtor to prepay the creditor to whom the undertaking is given to the extent a prepayment is made to other creditors.

5. Neither the pari passu clause nor the prepayment provision, however, is typically viewed by either creditor or debtor as of the same practical significance as the negative pledge clause. The pari passu clause, for example, does not prevent a debtor from, as a matter of practice, discriminating in favor of international financial institutions such as the Bank and the IMF in making debt service payments. The negative pledge clause, by contrast, affects both the debtor's effective ability to offer security concerning the repayment of existing loans and its ability to obtain certain forms of new financing.

(b) The Bank's Negative Pledge Clause 1/

6. The Bank's negative pledge clause places limits on the creation of a security interest in favor of other external creditors over assets of a member country and other entities which have borrowed from, or guaranteed loans made by, the Bank. (See Annex 1 for the full text of the Bank's negative pledge clause, as set out in Section 9.03 of the Bank's General Conditions Applicable to Loan and Guarantee Agreements, dated January 1, 1985.) The reason for requiring negative pledge clauses stems from the long standing policy of the Bank 2/ not to seek, in making loans, special

---

1/ The negative pledge clause is not included in IDA Credit Agreements.

2/ In 1950, Resolution No. 145 was passed by the Bank's Executive Directors. It held: "RESOLVED: That the Executive Directors approve the following statement of policy: As a general principle the Bank does not seek or accept liens on specific revenues or assets as security for loans to member governments. This principle does not preclude the operation of the usual negative pledge clause nor consideration of security from the member concerned. In other words, the Bank relies on the basic creditworthiness of the member as the basis for ensuring that its loans are serviced and repaid.[3/] While assessments of creditworthiness require evaluation of a number of complex factors and judgment about eventual willingness to repay, the ultimate factor is the availability to the obligor of foreign exchange at the time debt servicing obligations become due. Where existing assets or future income streams are "pledged" to certain external creditors in ways which effectively allocate foreign exchange to such creditors, the amount of foreign exchange available to service unsecured creditors, including the Bank, diminishes. It is this risk that the Bank's negative pledge clause seeks to reduce.[4/]

7. The core of the Bank's negative pledge clause is an undertaking by a member which has borrowed from, or guaranteed a loan made by, the Bank, that it will ensure that "no other external debt shall have priority over its loans in the allocation, realization or distribution of foreign exchange held under the control of or for the benefit of such member." (The General Conditions, Section 9.03 (a)).

8. The specific undertaking does not require a borrower to refrain from contractually agreeing to give priority to other creditors' claims, nor to refrain from granting so-called security interests over assets which could result in such creditors having priority access to foreign exchange. Rather, the undertaking is that:

> ...if any <u>lien</u> shall be created on any <u>public assets</u>..., as <u>security</u> for any <u>external debt</u>, which will or might result in a priority for the benefit of the creditor of such external debt in the allocation, realization or distribution of foreign exchange, such lien shall, unless the Bank shall otherwise agree, <u>ipso</u> <u>facto</u> and at no cost

---

security arrangements which may seem appropriate in light of existing liens or in other circumstances of particular cases."

3/ In 1948, the then Treasurer of the Bank stated that in his view the Bank's real security lay in the sound economic and financial position of the borrowing country. He stated that the taking of collateral weakened the Bank's ability to induce the country to "keep his house in order", because in taking collateral, the Bank would have less reason to "inquire deeply" into conditions in the borrower's country.

4/ In an internal memorandum to the Bank's Staff Loan Committee in 1954, it was stated that "[t]he basic purpose of the negative pledge clause is to protect the Bank against the use of governmental resources, or the use of governmental authority to mobilize other resources, to enable other foreign creditors to obtain foreign exchange in preference to the Bank through the creation of liens or priorities." (SLC/0/659)

> to the Bank, equally and ratably secure the principal of, and interest and other charges on, the loan, and the member of the Bank which is the Borrower or the Guarantor, in creating or permitting the creation of such lien, shall make express provision to that effect.... (The General Conditions, Section 9.03(a).) (Emphasis added.)

9. Assets Included Within the Scope of the Clause. The scope of the undertaking is broad. The breadth of the clause is shown, for example, by the definition of "public assets" in respect of which the member is undertaking not to grant security interest to other creditors without granting the same to the Bank. Public assets ("assets" include property, revenue, and claims of any kind) are defined in the General Conditions as

> "...assets of [a] member, of any political or administrative subdivision thereof and of any entity owned or controlled by, or operating for the account or benefit of, such member or any such subdivision, including gold and foreign exchange assets held by any institution performing the functions of a central bank or exchange stabilization fund, or similar functions for such member." (Emphasis added.)

Therefore, the negative pledge clause applies not only to assets owned directly by a member but also to assets which it owns indirectly and to assets of entities which operate for its account or benefit. The first category includes assets of governmental departments and instrumentalities and those of government-owned banks and companies. The second category includes entities, such as central banks, which, although not a subdivision of, or owned or controlled by the member, perform functions normally carried out by the government or other entities within the first category.

10. It is not, however, the pledging of any "public asset" which gives rise to the requirement that a similar pledge be granted for the benefit of the Bank: a lien must be created on public assets as "security" for "external debt" resulting in a priority for the benefit of the creditor of such external debt in the "allocation, realization or distribution of foreign exchange." In other words, the pledging of assets must affect the member's access to, or freedom in its ability to dispose of, foreign exchange. For example, the clause clearly "catches" not only obvious assets as gold and foreign exchange reserves, but also exportable assets,

such as crops or minerals, to the extent that they can be construed as "public". However, the negative pledge clause does not restrict the ability of a member to secure domestic indebtedness.[5]

11. <u>Types of Security Interest Included within Scope of the Clause</u>. The second area that reveals the breadth of the clause is the definition of security interests, or "liens". They are broadly defined in the General Conditions as including mortgages, pledges, charges, privileges and priorities of any kind. Thus, the negative pledge clause applies not only to formal security interests such as mortgages and pledges of collateral but to <u>any</u> arrangement that provides a preference for a creditor with respect to property. For example, the Bank has taken the position that an arrangement whereby a borrower agrees to maintain a deposit with a lender, thereby enabling the lender to exercise set-off rights against the borrower in case of default, is a "lien". The Bank has also objected to arrangements permitting creditors to surrender their claims in order to make payment of taxes because such arrangements establish a priority for such creditors with respect to the revenues of a member. The Bank has also been concerned by arrangements by which a member has agreed not to sell certain exports until it has first "sold" enough of those exports to a creditor to satisfy an antecedent debt.

12. <u>Exceptions</u>. The General Conditions provide for two exceptions to the application of the negative pledge clause. The first is for liens created on property, at the time of purchase thereof, solely as security for the payment of the purchase price of such property or as security for the payment of debt incurred for the purpose of financing the purchase of such property ("purchase money mortgages"). The purpose of this exception is to permit a borrower to finance new assets which will remain with the borrower after payment of the related financing and which can be expected to contribute to the borrower's wealth. The assumption here is that because the assets of the borrower available to pay all the borrower's creditors increase with the purchase of such assets, the Bank is not disadvantaged. Although the secured creditor who financed the asset is senior to the Bank and other unsecured creditors as to that asset, over time as the borrower repays that creditor, the borrower's "equity" in the asset will build up and consequently the assets available to pay the Bank and other unsecured creditors will increase. An example is financing to purchase ships or aircraft secured by a lien on the vessel. The exception could also apply to conditional sales contracts and capitalized leases.

13. The second exception to the negative pledge clause is for liens arising in the ordinary course of banking transactions and securing a debt

---

[5] "External debt" is any debt which is or may become payable in a currency other than that of the country which is the borrower or guarantor of the loans from the Bank.

maturing not more than one year after the date on which it is originally incurred. This exception recognizes that in order to permit the borrower to carry out its normal operations, a level of secured financing may be made by the borrower without prejudicing other lenders' interests. However, the exception is limited to short-term bank financing.

14. Certain Limitations to the Scope of the Clause. There are two important limitations to the scope of the negative pledge clause: (i) a significant range of transactions that may be considered to have the same economic effects as ones in which a security interest is created for external indebtedness may not be covered by the clause; and (ii) the clause does not affect the pledging of privately held assets.

(i) Transactions Possibly Outside the Reach of the Clause. Questions may be raised as to whether certain types of transactions having similar economic effects to liens are covered by the clause. These include advance payment arrangements, long term sales contracts, lease contracts, and trusts. For example, a member might sell commodity receivables, such as receivables for oil deliveries, on a limited recourse basis. Such arrangements may have the same economic effect as a borrowing secured against those earnings but may not be a technical violation of negative pledge clauses. Similarly, a member might enter into a sale and repurchase arrangement with respect to gold, whereby the member would agree to sell gold for a specific amount on terms that it will, at the option of the purchaser, buy back the gold for a higher amount at a set time. Although structured as a sale rather than a borrowing, the transaction could in substance be viewed as a loan to the member secured by gold, the difference between the sales price and the purchase price of the gold being the interest payable on the loan. We understand that other variations of such techniques are being studied in the market.[6/]

(ii) Privately Held Assets Excluded from Scope of the Clause. The Bank's negative pledge clause included in loan agreements with states or state enterprises includes within its scope the pledging of public assets held by third party public sector entities (i.e. entities which may have no borrowing relationship with the Bank). It does not, however, extend to the pledging practices of the private sector concerning privately owned assets, unless the Bank lends directly to a private entity. (The General Conditions, Section 9.03 (b).) As a practical matter, the fact that the range of the Bank's clause does not cover all assets of a country has probably been of marginal significance to most countries' ability to service and repay their Bank loans. For many of the countries which have been recipients of Bank loans, the public sector has constituted either the largest part of the overall economy, controlled access to foreign exchange,

---

6/ For a description of some of the transactions which have been discussed or taken place in recent months that have employed these techniques, see Annex 2.

or at a minimum has controlled the most important foreign exchange-generating sectors of the economy. Nevertheless, from a strictly financial perspective, this limitation on the scope of the Bank's clause has always been a potentially major limitation on the efficiency of the negative pledge policy in protecting the Bank against the prospect of a country's foreign exchange resources being effectively "reserved" for the securing of other creditors' claims or otherwise removed from government control (as in the case with private capital flight). With the accelerating trend for states to shrink their direct involvement in the productive economy, this potential limitation becomes of much greater practical importance.[7]

III. Application of the Bank's Policy

15. General. The Bank has rarely departed from its policy of not taking security in respect of its loans. In general, the Bank has only insisted on obtaining a security interest either when the borrower is a private entity or where a co-lender has insisted on taking such an interest. Most of the cases in which the Bank has taken a security interest, moreover, occurred in the early years of the Bank's existence. The predominant occasions on which the Bank has taken security in recent years have been in respect of IBRD-financed enclave projects in IDA-only countries.

16. Waivers. Given the far-reaching scope of the Bank's negative pledge clause, the Bank has always recognized that it should be administered with some flexibility. Moreover, since the inception of the policy, the Bank has from time to time been requested by governments to exempt certain specific transactions under negotiation from the ambit of the clause. In a very limited number of cases, the application of the clause has been waived in respect of transactions involving significant reserve assets of a member country. In general, however, the circumstances in which waivers have been granted have been limited to two types of situation:

7/ Whether one assumes an economy with a basically liberal exchange policy (where economic agents are generally allowed to choose freely if and to what extent they wish to exchange foreign exchange assets into local currency or assets) or an economy subject to major exchange controls (e.g. where economic agents other than the central bank are not allowed to hold any foreign exchange), the effective pledging of assets to foreign creditors by a private sector agent will have the same financially adverse impact on the state's access to foreign exchange for debt servicing purposes as will the pledging of assets by a public sector enterprise. From this perspective, for example, privatization, simply put, shrinks the volume of assets which come within the reach of the Bank's negative pledge clause.

(a) The Bank has waived the application of its clause in cases where the level of Bank exposure (both relative to other creditors and in absolute amounts) was de minimis and the waiver was not considered to pose any risks to the Bank as a creditor.

(b) The Bank has also on occasion waived its rights in the case of liens created by government-owned or controlled entities on their own assets and as security for their own borrowings. Such waivers normally have been given only at the specific request of the state authorities and for entities that meet the following criteria:

  (i) the entity is established as a business corporation and conducts its affairs along the lines of a private company;

  (ii) the entity is managed autonomously and is not included in the government's budget; and

  (iii) the entity's activities have no material financial or economic significance in relation to the ability of the government to service Bank loans.

  Waivers, however, have not normally been given for entities in the main foreign exchange-earning sectors of a country and, in some cases, financial ceilings may be imposed on the amount of debt the entity could secure.

However, recent developments in the overall debt strategy have led borrowers from the Bank to seek waivers in circumstances and involving magnitudes which have potentially far-reaching implications for the Bank.

17. The 1987-88 Mexico Debt Reduction. In late 1987, the Bank was asked to grant a limited waiver to Mexico in relation to the issuance by Mexico of bonds in exchange for a larger principal amount of bank loans. The principal amount of the bonds was secured by zero-coupon obligations issued by the U.S. Treasury. Because this proposed transaction clearly heralded a new phase in the debt strategy, in which debt reduction operations would constitute an important component, and because such transactions hinged on the provision of security for the resulting claims, Bank management undertook a careful review of the criteria to be employed by the Bank in determining the appropriateness of granting a waiver in respect of this operation. The evaluation of the case was carried out with special attention to two broad criteria relevant to the issue:

(i) the impact that granting a waiver might have on the Bank as a creditor and as a borrower; and

(ii) the relevance of the proposed transaction to the Bank as a development institution.

18. <u>Impact on the Bank as a Creditor and Borrower</u>. The first major concern was the possible adverse impact the waiver would have on the Bank's status as a preferred creditor and the possible resulting negative consequences for the Bank's market borrowing program. Senior management identified five considerations influencing the Bank's judgment as to the seriousness of these concerns in a particular situation:

- the magnitude of the amounts being secured in relation to the Bank's present and projected exposure in the country;

- the resulting total size of preferred and superior debt in relation to the country's total outstanding debt; the higher this ratio, the lower the maximum permissible Bank exposure; and allowing for the transaction, the "residual" debt servicing capacity of the country should still be satisfactory;

- whether other creditors had waived their negative pledge restrictions;

- the extent to which the country had avoided arrears in servicing its Bank loans and has made good efforts to honor debt service obligations to other creditors; and

- whether the scheme significantly increased the involvement of other creditors and, thereby, reduced the Bank's relative exposure without exceeding the country's overall debt servicing capacity.

19. The second major consideration, coming under the basic issue of the impact on the Bank of its granting waivers, was whether the operation in respect of which the waiver was requested could be reasonably expected to lead to an improvement in, or significantly contribute towards, a country's creditworthiness. If, for example, it was expected that such an improvement would occur in a country concerning which the Bank had serious questions about its ability to service Bank debt, this expectation could outweigh Bank concerns about the operation resulting in the Bank's share of unsecured claims on the country increasing.

20. <u>Relevance to the Bank as a Development Institution</u>. Whereas the criterion discussed above focusses on the financial well-being of the Bank itself, the second criterion focusses on the well being of the member country in question: was the proposed operation in the best developmental interests of the country? This required an evaluation not solely of the financial merits of the scheme, but also an assessment of its economic and developmental effects. Among the relevant elements in making such an assessment were: a consideration of feasible alternatives; the contribution to the financing needs of the country's development program; and the track record of the country in pursuing sound policies and maintaining compliance with Bank and IMF programs. These criteria were reflected in the

guidelines in respect of the Bank's program to support DDSR operations approved by the Executive Directors in May 1989.

21. In the 1987-88 Mexico case, the Bank concluded that the waiver was justified. Three factors were considered especially important. First, the foreign exchange reserves allocated to the transaction were restricted and consequently only a limited waiver was necessary. Second, the Bank's position vis a vis Mexico's external creditors (other than the bondholders) was maintained because of corresponding waivers granted by them. Third, Mexico had a satisfactory payment record and confirmed that the Bank's loans would continue to be serviced in a timely manner and would not be subject to rescheduling.

22. Waivers in respect of DDSR Operations under the Strengthened Debt Strategy. Since the inception of the program to support debt and debt service reduction (DDSR) operations approved by the Board in May 1989, the likelihood of waivers being sought of the Bank in respect of its negative pledge clause has increased significantly. Until that time, commercial financing relief packages for heavily indebted countries consisted essentially of the provision of new money and the rescheduling of principal. No security was provided in respect of the affected debt obligations (although the Bank did provide partial guarantees of a portion of the principal in connection with commercial new money facilities extended to Chile in 1985 and Mexico in 1987). Under the strengthened debt strategy, however, it was explicitly envisaged that commercial claims might be restructured, either through a reduction in their face value or in respect of the applicable interest rate, in return for the creation of "enhancements" on the resulting claims. The May 1989 program approved by the Bank established the availability in principle of financing resources from the Bank for such enhancements and established the criteria pursuant to which such resources could be made available to individual member countries. Where the Bank approves the provision of its resources to finance or cofinance the collateralization of restructured commercial debt, the policy decision for the Bank to grant a waiver of its negative pledge clause with respect to that collateral is straightforward.

23. 1990 Mexico DDSR. To date, only one DDSR operation involving Bank financing for collateralization purposes has been approved: the 1990 Mexico DDSR package, in which the Bank agreed to provide a limited waiver of its negative pledge clause in respect of the collateralized bonds issued thereunder. As the debt workout process continues, it is expected that the resources of the Bank, other IFIs, and certain bilateral sources will be made available to other countries to permit the collateralization of restructured commercial claims. (Term sheets have been circulated for Venezuela proposing such collateralization). Where Bank resources are so employed, the precedent with respect to the granting of waivers established in the case of Mexico may be expected to be followed.

24. 1990 Debt Strategy Review Paper Recommendations. Following the Mexico package, the Board discussed the issue of negative pledge waivers in the context of a "Review of Progress under the Program to Support Debt and Debt Service Reduction" (R90-48, dated March 21, 1990). Directors generally supported a restrictive practice of not providing waivers, other than for the assets providing collateral in Bank-supported programs.

25. 1990 Costa Rica DDSR. Subsequently, in May 1990, the Bank agreed to provide a limited waiver of its negative pledge clause for Costa Rica, even though no Bank financing was provided for the DDSR operation. The case was deemed to be unique in that the timing of the operation prevented the Bank from providing direct financial support. The circumstances precluding Bank funding were, however, viewed as temporary and, in the circumstances, the Bank decided that a waiver was justified in this case as if the Bank were directly supporting the debt reduction operation. The following considerations were considered pertinent: (a) the borrower's established practice in promptly servicing its debt obligations to the Bank; (b) the borrower's written commitment, set out in its letter requesting the waiver, that it will continue to service all present and future Bank loans on the dates provided for in the loan agreements, and its acknowledgment (also in the same letter) that Bank loans will not be subject to rescheduling; and (c), most fundamentally, because the pledging of assets was taking place in the context of, and as a vital part of, a debt and debt service reduction operation which had been assessed by the Bank as constituting a key component in the country's medium term financing plan, thereby making a material contribution to the country's development prospects. In granting the waiver requested, the Bank also made it clear that it was limited to the specific transactions described in the borrower's waiver request letter and to a fixed maximum amount, and that such waiver was granted without prejudice to the Bank's position on the negative pledge restriction under its loan and guarantee agreements in general. In this respect, the waiver of the negative pledge for Costa Rica was similar to that granted Mexico in early 1988.

IV. Some Recent Developments which Raise Issues Concerning the Bank's Negative Pledge Policy

26. As countries seek to obtain financial relief agreements with their commercial creditors under the revised debt strategy or seek new credits after completing DDSR operations, it is likely that they will request the Bank to provide waivers which go beyond the practice described above. It is also likely that the Bank will be confronted with transactions which purport not to fall within the scope of the Bank's negative pledge clause, but which nevertheless will provide commercial creditors with substantially the same comforts as those to be obtained from the creation of security interests and which will certainly have the same economic effects. This section identifies some types of waiver requests that may be presented,

some operations purporting to escape the ambit of the negative pledge, and some of the considerations underlying these likely developments.

Possible Forthcoming Waivers Requests.

27. Waiver Requests for Non Bank-Funded DDSR Operations. Requests are likely to continue to be be made by creditor countries to waive the application of the Bank's negative pledge clause in respect of DDSR operations for which the Bank is not providing financing. The reasons for such requests may vary: available enhancements under the 1989 program may have been exhausted, the contemplated transaction may be limited in size, or the debtor may simply have access to alternative financing.

28. New Money Waivers. Sovereign borrowers may seek waivers of the Bank's negative pledge clause in order to obtain secured new money borrowings. These requests may be presented to facilitate refinancing operations, in which case they may be presented as part of an overall debt relief package; or they may be sought separately to permit genuinely voluntary transactions (e.g. for new investment projects).

29. For many countries, the issue of obtaining new money will probably not be particularly relevant.[8/] Nevertheless, there is a broadly held view that the prospects for providing new money for some countries would be significantly increased to the extent that the same kind of enhancements that are provided for DDSR instruments are made available for new money. The consequence is that it is possible that the Bank will be requested by certain countries to provide limited waivers for collateralized new money transactions in the future.

30. Countries with severe debt problems may also seek to raise additional capital, typically for new projects, from increasingly reluctant international markets. It is likely that creditors will seek special protection for any loans as a condition of lending in view of such borrowers' doubtful records or capacity to honor unsecured obligations. In these circumstances, member countries may seek waivers of the Bank's negative pledge clause in order to secure these borrowings.

8/ The factors identified in the 1990 debt strategy review paper (see Board Memorandum R90-48, paragraphs 41-44) underlying the accelerating trend towards banks not participating in new money options in debt workout packages are likely to persist and provide no grounds to believe that new money will constitute a major component of such packages in the future, irrespective of any decision to allow collateralization of such borrowings.

Circumventions of the Negative Pledge Clause.

31. As a practical matter, it is very unlikely that there is universally careful adherence to the Bank's negative pledge policy on the part of state entities caught within the ambit of the Bank's negative pledge clause (see paragraph 9). In many instances, this can be explained by ignorance as to the scope (and undoubtedly sometimes the existence) of the clause.[9/] However, there are indications that certain financing transactions are being constructed in ways essentially intended to circumvent the reach of negative pledge clauses. Transactions of the type described in Annex 2 are illustrative.

32. In the majority of such instances, the practical implications for the "quality" of the Bank's claims are probably negligible. However, there is a risk that the sort of techniques that have hitherto been of marginal relevance to the essential integrity of the Bank's negative pledge policy might be applied in respect of new money and DDSR operations on a scale which will have a major impact on the continued effectiveness of the Bank's policy.

V. Recommendations

33. The primary objective of this paper has been to address the issue of the negative pledge clause in the context of DDSR operations, including those not directly supported by the Bank. Any change in the current policy in this area poses some risks to the Bank and may encourage countries to seek waivers rather than exploring other options. Nevertheless, substantial benefits may also result from granting waivers in certain cases. In addition, an important consequence of the debt crisis will be protracted difficulties in maintaining adequate financing flows to many countries. Access to voluntary financings from the private loan and capital markets have been drastically curtailed, and there has been a sharp cut back in the provision of export credit coverage. To the extent other sources of capital have dried up, there will be greater demand on the Bank's and other official sources for new borrowing. Security arrangements are increasingly seen as critical to obtaining financing for debt relief and fresh funds from private markets, and access to more private funds may reduce the pressure on official sources.

34. The basic purpose of the Bank's negative pledge clause, as described (see paragraph 6), has always been to protect the Bank against the commitment of governmental resources, or the use of governmental authority to mobilize resources, to enable other foreign creditors to obtain foreign exchange in preference to the Bank through the creation of

---

9/ Many state enterprises with potential foreign exchange-generating assets are not borrowers from the Bank.

liens or other priority interest. Management continues to support this fundamental objective of the negative pledge clause. However, attaining an appropriate response to the developments described in Section IV will involve a delicate balance between the Bank's interest in facilitating a country's access to appropriate external financing and the Bank's concern in ensuring the "security" of its own loans to such country. Based on the foregoing considerations, Management recommends the following clarifications and affirmations of the Bank's policy on waivers to the negative pledge clause:

(a) DDSR Operations. The Bank's policy of granting waivers in connection with Bank-financed DDSR operations should continue. For DDSR operations for which no Bank financing is being provided, the Bank should be prepared to consider waiver requests on a case-by-case basis, applying, for the purposes of evaluating the merits of the particular requests, the criteria applied in the 1987-88 Mexican debt reduction operation (see paras. 17-21). These guidelines will provide assurance that the Bank's interests are well protected and that the operation has clear developmental benefits to the country. The Board's approval would be sought in each instance where a positive response to a waiver request is contemplated.

(b) New Money Operations. The Bank's policy of not granting waivers for enhancements of new money in the context of concerted financing packages should be continued. Regarding waivers related to the foreign currency component of project or other lending, existing policies concerning public enterprises effectively separated from the government (paragraph 16), purchase money mortgages (paragraph 12), and liens arising in the ordinary course of banking transactions securing debts maturing not more than one year from the date originally incurred (paragraph 13), should prove sufficient to address most legitimate needs without inviting borrowers or the market to demand waivers more generally. Exceptions would, of course, be considered on their merits on a case-by-case basis. [10] Should experience indicate a pressing need for reconsideration of this view, the matter will be brought to the Board for further review.

(c) Circumventions of Negative Pledge Clause. Overall, the ambit of the Bank's negative pledge clause is sufficient to protect the Bank's interests. Moreover, the Bank should continue to enforce these provisions of its loan agreements. Nevertheless, there are, and will continue to be, transactions which are structured so as to escape the ambit of the Bank's negative pledge clause, even

---

[10] For a summary overview of the implications of allowing collateral enhancements, for new money borrowings, see Annex 3.

though they may have the same economic effect as a straightforward pledging of assets. It is extremely doubtful that any "tightening up" of the negative pledge clause could eliminate or even substantially reduce the incidence of such practices. No revisions to the language of the negative pledge clause are therefore recommended at this time. However, if there are cases where countries systematically abuse or try to circumvent the intent of the clause, this would raise concerns about the overall creditworthiness of that country for Bank lending, and consequently be a subject for resolution in the context of our overall country dialogue and operational program.

Barber B. Conable

THE WORLD BANK'S NEGATIVE PLEDGE CLAUSE
(Section 9.03 of the General Conditions)

Section 9.03. **Negative Pledge.**

(a) It is the policy of the Bank, in making loans to, or with the guarantee of, its members not to seek, in normal circumstances, special security from the member concerned but to ensure that no other external debt shall have priority over its loans in the allocation, realization or distribution of foreign exchange held under the control or for the benefit of such member.

(i) To that end, if any lien shall be created on any public assets (as hereinafter defined), as security for any external debt, which will or might result in a priority for the benefit of the creditor of such external debt in the allocation, realization or distribution of foreign exchange, such lien shall, unless the Bank shall otherwise agree, ipso facto and at no cost to the Bank, equally and ratably secure the principal of, and interest and other charges on, the Loan, and the member of the Bank which is the Borrower or the Guarantor, in creating or permitting the creation of such lien, shall make express provision to that effect; provided, however, that if for any constitutional or other legal reason such provision cannot be made with respect to any lien created on assets of any of its political or administrative subdivisions, such member shall promptly and at no cost to the Bank secure the principal of, and interest and other charges on, the Loan by an equivalent lien on other public assets satisfactory to the Bank.

(ii) As used in this paragraph, the term "public assets" means assets of such member, of any political or administrative subdivision thereof and of any entity owned or controlled by, or operating for the account or benefit of, such member or any such subdivision, including gold and foreign exchange assets held by any institution performing the functions of a central bank or exchange stabilization fund, or similar functions, for such member.

(b) The Borrower which is not a member of the Bank undertakes that, except as the Bank shall otherwise agree:

(i) if such Borrower shall create any lien on any of its assets as security for any debt, such lien will equally and ratably secure the payment of the principal of, and interest and other charges on, the Loan and in the creation of any such lien express provision will be made to that effect, at no cost to the Bank; and

(ii) if any statutory lien shall be created on any assets of such Borrower as security for any debt, such Borrower shall grant at no cost to the Bank, an equivalent lien satisfactory to the Bank to secure the payment of the principal of, and interest and other charges on, the Loan.

(c) The foregoing provisions of this Section shall not apply to: (i) any lien created on property, at the time of purchase thereof, solely as security for the payment of the purchase price of such property or as security for the payment of debt incurred for the purpose of financing the purchase of such property; or (ii) any lien arising in the ordinary course of banking transactions and securing a debt maturing not more than one year after the date on which it is originally incurred.

RECENT FINANCING PACKAGES

There have been a number of financing transactions in recent months which have made use of the existence of accounts receivable. For example: a major U.S. bank recently arranged an $800 million private placement Eurobond offering for a state-owned telephone company of a large heavily indebted country. The bonds were secured by a claim against the company's accounts receivable from a major U.S. telephone company. Since the telephone traffic patterns between the country in question and the U.S. are such that the U.S. telephone company will owe the state telephone company approximately $1 billion per year for the foreseeable future, the principle risks to the investors were that the U.S. telephone company would refuse to pay the state telephone company. Investors were apparently willing to bear this essentially non-heavily indebted country (HIC) risk since the bonds were well secured and priced to yield approximately 14%.

On the basis of a similar accounts receivable security package, a U.S. bank underwrote loans for the telephone companies in two Southern Hemisphere countries and another U.S. bank arranged a deal for a third Latin American country's telephone company. In addition, a U.S. investment bank recently underwrote a $235 million private placement for a state-owned HIC electricity company. Since this company sells excess electricity to various Southern California utilities, the accounts receivable from the U.S. utilities were used as collateral for that deal as well.

Long term sales contracts are also becoming a popular component of loan security packages. A private HIC copper company and several state-owned HIC chemical companies recently raised capital on the strength of long term purchase contracts from creditworthy companies in developed countries. In a variation on the long term sales contract theme, several African countries have been using export retention agreements to guarantee dividend and profit remittances on foreign direct investment. These export retention arrangements are fairly simple and straightforward: In exchange for making a new investment in an export-oriented sector of the economy, a foreign investor is given permission to retain a portion of the project's export proceeds offshore, rather than remitting them directly to the central bank. The offshore proceeds are used to pay for essential imports in addition to providing a guaranteed source of dividend and profit remittances.

All of these deals share at least one common feature: Payments due from the accounts receivable, long term sales contracts, or exports were not remitted to the home country. Instead they were deposited directly into offshore escrow accounts and reserved exclusively for debt service payments. By ensuring that the hard currency revenues bypass the central bank, the financial markets hope to minimize the political, country and transfer risk problems associated with doing business in debt-distressed countries.

Escrow accounts, however, are not the only technique used to insulate hard currency earnings from the central bank's "jurisdiction". Several Latin American and Eastern European hotel companies have recently used advance payment arrangements to accomplish the same goal. Under the terms of these deals, a hotel company pre-sells large blocks of rooms to is wholly-owned offshore subsidiary. In return for the exclusive right to those rooms, the subsidiary agrees to borrow in the international capital markets on behalf of the hotel company, securing its loan with the proceeds of room reservations which the subsidiary expects to sell to U.S. and European travel agencies. By proceeding in this fashion, the on-shore hotel companies gain access to hard currency for modernization and expansion and the lenders gain access to an offshore source of repayment that is insulated from political and transfer risk and totally outside the control of the central bank. In other words, no hard currency enters the country in the form of hotel room revenues and no hard currency has to be obtained from the central bank for debt service payments. It is also clear that advance payment deals do not have to be restricted to hotel transactions. On the contrary, they were initially devised as a form of limited recourse financing for minerals project and only recently used in the tourist sector.

Numerous cross-border financings take the form of lease contracts, which, share many of the same features as advance payment arrangements. Both are off-balance sheet financing techniques in the sense that the parent company does not incur a liability. In addition, both use offshore export revenues to finance the acquisition of capital equipment. However, instead of financing the acquisition of a piece of capital equipment with the proceeds of an international loan or an advance payment from an offshore subsidiary, a local company leases the equipment from a financial institution or some offshore entity (which may in fact be a wholly-owned subsidiary of the on-shore company). Furthermore, rather than making debt service payments, the local company makes periodic rental payments, either in the form of hard currency or, more typically, in the form of exports which the leasing company then sells in the international market for hard currency.

Trusts have also become increasingly popular vehicles for raising financing on a secured basis: funds are raised in the markets by the trust secured wholly or in part by assets of such trust (assets which might have originated from the proceeds of the borrowing itself). The funds are then on-lent to a state or state enterprise. While such devices can assume very complex characteristics, their rationale appears to lie in the attainment of a simple objective: the avoidance of negative pledge restrictions.

NOTE: In describing the above illustrative transactions, no view is expressed by Bank staff as to whether such transactions are caught by the Bank's negative pledge clause. Each such transaction would have to be examined in detail before any such view could be formed.

IMPLICATIONS OF ALLOWING COLLATERAL ENHANCEMENTS FOR NEW BORROWINGS

Providing negative pledge waivers by heavily indebted countries is not necessarily without benefit to the economic programs of these countries. Many countries are seeking additional capital to fund priority projects and have no access to additional borrowing by normal means. Pledging of assets offers certain advantages in this regard.

First, it is argued that establishing such security relationships will significantly increase access to commercial cross-border financings in today's markets. As recent experience has shown, there are few examples of voluntary commercial cross-border lending to most highly indebted countries which are not secured. Second, transfer risk continues to be a pervasive concern to many potential lenders, and lenders are naturally seeking arrangements which reduce or obviate that risk altogether. Third, in the context of an environment in which workouts increasingly entail the generation of enhanced bonds, many potential lenders view such operations as in effect subordinating any unenhanced or unsecured new loans to existing claims. Obtaining security to offset this situation is a sine qua non for many potential lenders to engage in voluntary new lending.

Another advantage associated with these relationships is that they suggest that even highly indebted countries can return to the international loan and capital markets when the various risks associated with cross-border lending are "unbundled" and managed individually. Loans "secured" only by a country's full faith and credit are, almost by definition, not conducive to this unbundling process.

It is also probably correct to state that the security arrangements which lenders require have as much to do with economy-wide concerns as they do with concerns about the management and financial practices of the prospective borrower. Concerns about the way a non-sovereign borrower manages its affairs are typically addressed through the insertion of covenants establishing minimum debt equity ratios, debt coverage ratios, etc. These are the covenants which are intended to guard against the prospect of subsequent loans reducing the borrowers' capacity to service prior obligations. Escrow accounts and similar arrangements are typically resorted to in sovereign lending in order to guard against the risks posed by economy-wide mismanagement resulting in excessive build-ups of hard currency claims or reduction in the amounts of foreign exchange available to service liabilities by "dedicating" some of these assets or earnings to the loan in question.

Pledging of assets or revenues also has its risks, both to the borrower and to other creditors, such as the Bank. Most basic, of course, is the concern that gave rise to the negative pledge clause in the first place: that the assets being pledged will shrink to a dangerously low level the pool of available resources to which the Bank looks for servicing its loans (see paragraph 6). Such a process of encumbering assets and future income flows also runs against one of the fundamental objectives of the Bretton Woods institutions: to promote the increasing liberalization of trade and financial flows in a generalized system of free exchange of goods and capital. Furthermore, to the extent that commercial lenders can isolate individual flows to secure their loans, they also become less concerned with the quality of the overall economic management of the borrowing country. At the limit, access to such secured capital could reduce a debtor's interest in following a Bank or Fund program.

Secured borrowing may not be in the best developmental interest of a debtor either. The pre-allocation of assets or income streams to certain obligations reduces the country's flexibility in the future to devote scarce foreign exchange resources to the highest priority uses. In the immediate term, countries may be induced to invest in projects based on their ability to secure lending rather than on their priority in the government's overall development strategy. When capital is very scarce, such distortions may be severe if a "financable" project requires substantial supporting public investment. When lenders can secure repayment of loans on very safe income streams, future oil revenues for example, they may again become more lax in their own project appraisal, relying on the pledged assets more than the project's profitability for repayments, much as they once relied on the sovereign guarantees of governments. However, in this case, they are much more likely to get paid regardless of large future competing demands for foreign exchange.

These advantages and disadvantages must be weighed in any reconsideration of the Banks' negative pledge waiver policies. From a financial institution point of view, waivers may increase the risks borne by the Bank, but they may also induce other lenders to increase their exposure, thereby possibly reducing the Bank's relative or absolute exposure. From a development institution point of view, waivers may lead to more costly, less efficient, and less carefully monitored borrowing from capital markets, but they may also allow the country to finance additional investment (or debt reduction) that would enhance future growth prospects. These are important considerations in the harsh and risky circumstances of many of our highly indebted members.