

# THE UNITED STATES AGENCY FOR INTERNATIONAL DEVELOPMENT AS CATALYST FOR DEBT-FOR-NATURE SWAPS

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If we can remember to think about the future as well as the present, and can afford to do so, there is a chance for the environment of the world.

— Charles W.T. Stephenson  
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“Future Singing” (unpublished)  
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This comment examines how the U.S. Agency for International Development (“AID”) has evolved into a catalyst promoting the Debt for Nature swap (“DFN”).<sup>1</sup> The comment will show that although conceived largely as a means for providing debt relief to overburdened LDCs, the DFN has proven to be an effective tool to promote LDC environmental conservation. Correspondingly, with congressional and administration support and in conjunction with its foreign assistance objectives, AID has developed a program to promote, facilitate, and implement DFNs. Part I of the comment explains how the DFN developed from efforts to address the international debt crisis, with environmental concerns playing a secondary role. Part II describes how Congress established the environmental focus of AID’s role in promoting DFNs, while granting primary control over debt reduction policies to the Treasury Department. Part III reviews the organizational structure established by AID to promote DFNs, and Part IV describes AID’s focus upon its programs abroad instead of its domestic political concerns.

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1. A DFN involves the purchase of debt owed by a lesser developed country (LDC) to a commercial lender. The purchaser, usually an environmental group, cancels the debt in return for the debtor’s commitment to create a cohesive national environmental policy or support a specific environmental project.

In a May 1988 meeting at the State Department, Deputy Treasury Secretary M. Peter McPherson espoused the virtues of DFNs, and challenged AID to become a catalyst for their implementation.<sup>2</sup> McPherson's speech was noteworthy because it provided impetus for AID to address the concerns of its critics.

Consistent with its mandate of promoting market economies abroad, AID provides grants, loans and advice to LDCs to stimulate economic development.<sup>3</sup> Although these activities draw objections from disparate camps, AID's involvement in DFNs could serve to defuse criticism. For instance, environmental interest groups are unconvinced of AID's commitment to the environment. They characterize multilateral and bilateral development efforts as largely blind promotion of economic transformation in blatant disregard of environmental preservation.<sup>4</sup> AID's active promotion of

2. M. Peter McPherson, Remarks at the Debt for Development Conference, Department of State, Washington, D.C. (May 23, 1988) [hereinafter McPherson Remarks].

3. Reflecting AID's agenda, the Foreign Assistance Act of 1961 [hereinafter Foreign Assistance Act] provides that:

The Congress finds that fundamental political, economic, and technological changes have resulted in the interdependence of nations. The Congress declares that the individual liberties, economic prosperity, and security of the people of the United States are best sustained and enhanced in a community of nations which respect individual civil and economic rights and freedoms and which work together to use wisely the world's limited resources in an open and equitable international economic system. Furthermore, the Congress reaffirms the traditional humanitarian ideals of the American people and renews its commitment to assist people in developing countries to eliminate hunger, poverty, illness, and ignorance.

Therefore, the Congress declares that a principal objective of the foreign policy of the United States is the encouragement and sustained support of the people of developing countries in their effort to acquire the knowledge and resources essential to development and to build the economic, political, and social institutions which will improve the quality of their lives.

United States development cooperation policy should emphasize four principle goals:

(1) the alleviation of the worst physical manifestations of poverty among the world's poor majority;

(2) the promotion of conditions enabling developing countries to achieve self-sustaining economic growth with equitable distribution benefits;

(3) the encouragement of development processes in which individual civil and economic rights are respected and enhanced;

(4) the integration of developing countries into an open and equitable international economic system.

The Congress declares that the pursuit of these goals requires that development concerns be fully reflected in United States foreign policy and that the United States development resources be effectively and efficiently utilized.

22 U.S.C. § 2151 (1978).

4. Swire, *Tropical Chic: Saving the Rain Forests from Their Saviors*, THE NEW REPUBLIC, Jan. 30, 1989, at 18.

DFNs could demonstrate resolve and thus defuse such opinions. Further, federal budget watchers question whether the U.S. should extend grants totalling billions of dollars for overseas development projects when the cumulative national budget deficit expands alarmingly each year.<sup>5</sup> In this light, by bargaining for a favorable exchange rate in its deals, AID's DFN activities could increase the impact of its expenditures and thus reduce the need for increased budget allocations.

## I. THE DEBT CRISIS AND THE DEBT CONVERSION REMEDY

The DFN emerged from efforts to address the international debt crisis. Thus, an understanding of AID's initial participation in DFNs requires some background knowledge of the debt crisis and the U.S. reaction to it.

The debt crisis resulted from the tremendous amount of money lent by commercial banks to LDC borrowers in the 1960s and 1970s, and the subsequent inability of these borrowers to repay the loans. Believing that sovereign debt was immune from default, commercial lenders advanced vast sums to developing countries to generate economic growth and a subsequent demand for new credit. Simultaneously, public institutions extended loans to LDCs at low interest rates to invigorate the stalled economies. Furthermore, international financial institutions adopted liberal lending practices aimed at developing profitable foreign markets and enhancing worldwide political stability.

The ability to obtain credit at favorable terms induced some LDC governments to borrow enormous sums to fund development efforts. While often triggering rapid economic growth, most advances facilitated by these borrowings were superficial and ephemeral. Even worse, despite heavy borrowings many LDC economies failed to grow at all.<sup>6</sup> As these economies slipped, public and private lenders attempted to inject additional funds into the economies. These lenders aimed to induce growth in order to permit repayment of existing loans, and to preserve a measure of economic and political stability. Unfortunately, interest expenses requiring payment in hard currency continued to rise as LDC governments

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5. For example, the Administration has announced a plan to forgive a portion of Poland's debt. John Chancellor of NBC News criticized this decision, claiming that it sends an unclear message to other debtor nations and that the U.S. should not forgive other nations' debt while deeply in debt itself. *NBC Nightly News* (NBC television broadcast, Mar. 19, 1991).

6. Most commentators agree that the oil shocks of the early 1970s played a major role in the disastrous performance of many LDC economies. See Comment, *Debt-for-Nature Swap: A Long-Term Investment for the Economic Stability of Less Developed Countries*, 24 INT'L LAW. 1071, 1072 (1990).

increased their borrowings, and consequently the governments were forced to allocate less hard currency for domestic investment. In particular, the increased interest payments forced LDC governments to sharply curtail critical imports essential to economic growth.

As these difficulties worsened, some debtor LDCs (such as Mexico in 1983) lapsed into default on their loans. Responding to the defaults, creditors changed their LDC lending practices. Rather than injecting more money into debtor economies to stimulate growth, banks ceased new lending to avoid additional exposure. Furthermore, foreign direct investment in debtor LDCs, another means of accumulating badly needed hard currency, dropped off significantly. LDCs owed about \$1.3 trillion to a variety of creditors, including commercial banks, bilateral organizations, and multilateral institutions.<sup>7</sup>

Loan defaults by over forty LDC governments since 1983 has left many commercial and public creditors with large portfolios of potentially uncollectible debt.<sup>8</sup> Consequently, the debt crisis has adversely affected the economies of many developed nations as well as those of LDCs.

## A. The Treasury Department Responds to the Debt Crisis

### 1. The Baker Plan

In an effort to contain the debt crisis, U.S. Treasury Secretary James Baker launched his "Program for Sustained Growth" ("the Baker Plan") in October 1985 at the IMF/World Bank annual meeting in Seoul, South Korea. Baker sought to promote economic growth in debtor LDCs through tax overhauls, privatization, and deregulation, combined with new commercial and multilateral development bank lending. Baker's initiative aimed at gradually easing the LDC debt burden, thus aiding economic growth and capital formation; promoting necessary market reforms in debtor LDCs; halting capital flight and attracting domestic investors with funds overseas; and tailoring reform efforts to the particular needs of each LDC.<sup>9</sup> Nonetheless, although the Baker Plan received praise for its

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7. U.S. OVERSEAS COOPERATIVE DEVELOPMENT COMMITTEE, VOLUNTEERS IN OVERSEAS COOPERATIVE ASSISTANCE & THE DEBT-FOR-DEVELOPMENT COALITION, *A GUIDE TO DEBT FOR DEVELOPMENT: MAKING THE INTERNATIONAL DEBT CRISIS WORK FOR DEVELOPMENT*, at iii (1990) (available from the Development Coalition) [hereinafter DDC GUIDE].

8. *Debt-for-Nature Swaps: A New Conservation Tool*, 1 WORLD WILDLIFE LETTER 3 (1988). Crushing debt burdens continue to plague many LDC economies. For example, Peru (1985), Ecuador (1987), Argentina (1988), and Brazil (1989) have halted interest payments on most of their commercial debt. Washington Post, Dec. 6, 1990, at B1, col. 1.

9. McPherson Remarks, *supra* note 2.

promotion of bold measures, it failed to spur growth as intended.<sup>10</sup> Consequently, new incentives were necessary to gain the support of commercial lenders and encourage LDC governments to implement essential restructuring policies.<sup>11</sup>

## 2. Debt-for-Development Initiative Addresses the LDC Debt Crisis

Baker's successor at the Treasury Department, Nicholas F. Brady, attempted to develop a program providing new incentives for the restructuring of LDC economies and for renewed lending by commercial banks. While continuing Baker's agenda, in March 1989 Brady added a program that included multilateral bank debt rescheduling and his "Debt-for-Development Initiative" ("the Debt Initiative").<sup>12</sup>

Brady's Debt Initiative featured prominently his promotion of debt conversions, in which the form of debt instrument is changed without altering the nominal sum owed. Brady focused upon three popular forms of debt conversion. First, instead of receiving principal and interest payments in hard currency, lenders would gain an ownership stake in an enterprise located in a debtor LDC. For example, bank X would forgo cash payments from debtor LDC Y in exchange for an equity interest in a factory in Y. Such arrangements are often referred to as "debt-for-equity swaps". The second conversion involves exchanging another type of liability, such as a bond denominated in the debtor's currency, for the outstanding loan. For example, a creditor would cancel LDC Y's hard currency debt in exchange for an obligation of repayment in local currency. In the third form of debt conversion, the lender would forgive the LDC loan, whether canceling the debt outright or donating the loan to another institution to be used in a subsequent exchange.

Not surprisingly, these forms of conversion did not attract many lenders. After all, why would a bank want a risky equity stake in a foreign factory, or repayment for its loan in an unstable currency? The debt conversion mechanisms did, however, attract speculators to a secondary market, in which creditors tried to sell their LDC loans in order to reduce and diversify their exposure. In the secondary market, lenders offered LDC loans at dramatic dis-

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10. *U.S. Policy May Shift on LDC Debt Dilemma*, J.COMMERCE, Nov. 17, 1988.

11. Some investment banks proposed modifications to the Baker Plan. For instance, Salomon Brothers suggested three possible additions: conversion of LDC loans into long-term bonds with concessions to the debtors; interest concessions to LDC debtors; and an increase in World Bank loans to LDCs in order to retire loans to commercial banks. Such proposed modifications to the Baker Plan aimed to generate a new and steady flow of commercial bank lending, thus providing LDCs with necessary financing to promote domestic economic stability and growth. *Id.*

12. DDC Guide, *supra* note 7, at iii.

counts from face value. Lured by the low price of these loans, private investors began to enter the secondary market.<sup>13</sup>

By 1989, the total face value of LDC debt offered on the secondary market increased to over \$20 billion. The market's growth was spurred by debt conversion programs introduced by an increasing number of LDCs, including Chile, Mexico, Brazil, Ecuador, Venezuela, Argentina, and the Philippines.<sup>14</sup> These programs increased investors' confidence concerning the profitability of the secondary market, and made debt-for-development an accepted and reliable means of LDC debt reduction.

#### B. Out of the Debt Conversion Mechanism Came DFNs<sup>15</sup>

As LDC economies staggered from tremendous debt burdens, the environmental conditions in these nations deteriorated severely. For instance, to generate hard currency many LDCs began to exploit renewable resources for export, such as harvesting timber in tropical forests. Although such policies yielded immediate income, the resultant destruction of the environment eroded the LDC's renewable resource base and hence threatened long-term stability.

Moreover, even those LDC governments that wished to safeguard natural resources often lacked the technical or financial capacity to implement effective programs. These governments were obligated to use scarce hard currency reserves for debt repayment rather than for investment projects. As a result, environmental protection received low priority. In this light, some observers criticize international development organizations for contributing to environmental degradation because the organizations' austerity measures discourage LDC governments from adopting a long-term approach towards environmental preservation.<sup>16</sup> For instance, institutions such as the IMF generally insist upon a reduction of spending in all possible areas to provide for debt payments.

The idea that environmentalists could use the debt crisis to their advantage was proposed in a newspaper article in 1984 by Dr. Thomas Lovejoy, then Vice President for Science of the World Wildlife Fund - U.S.<sup>17</sup> Lovejoy's *New York Times* editorial linked the international debt crisis to the degradation of fragile natural environments of the developing countries. He sought to remedy the situation by proposing the use of the debt conversion mechanism for environmental conservation purposes. He urged,

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13. S.T. Chew, *Debt Swapping for Development: Boon or Boondoggle?* at 4 (June 1990) (unpublished manuscript for AID).

14. *Id.*

15. For a comprehensive analysis of DFNs, see Gibson & Curtis, *A Debt-for-Nature Blueprint*, 28 COLUM. J. TRANSNAT'L L. 331 (1990).

16. See, e.g., Comment, *supra* note 6, at 1075.

17. Lovejoy, *Aid Debtor Nations' Ecology*, N.Y. Times, Oct. 4, 1984, at A31, col. 1.

[W]hy not use the debt crisis - which seems to be meaning financial gridlock - to help solve environmental problems? . . .

The consequences of such a step would be felt long after the debt problem is history. It would not require new infusion of hard currency, would contribute to local economies, would improve debtor ability to pay off . . . outstanding loans and, not least, it might give creditor countries a measure of satisfaction.<sup>18</sup>

Thus the DFN was born. DFNs are international debt conversions for the benefit of environmental private voluntary organizations ("PVOs"). PVOs fund their environmental projects first by purchasing or receiving donations of LDC debt. The PVO then enters into a conversion agreement with the debtor LDC government. According to the agreement, the PVO cancels the hard currency debt in return for the LDC government's commitment to an environmental conservation program chosen by the PVO, or for payment of local currency to a specific fund that supports the project.<sup>19</sup>

The first DFN took place in Bolivia in 1987, with Conservation International acting in conjunction with the Bolivian government to establish the Beni Biosphere Reserve. By July 1990 there were twelve completed DFNs, with many others under negotiation.

## B. DFNs Benefit All Parties Adversely Affected by the LDC Debt Crisis

The DFN seeks to benefit three principal parties adversely af-

18. *Id.*

19. The DFN process is extremely complicated, requiring several months and even years of complex negotiations to complete. As Betsy Cody has noted,

At a minimum, the following must take place in order for a debt-for-nature swap to be successful:

- the debtor country must have a debt-for-equity mechanism in place or be willing to establish such a policy;
- the debt must be available from a commercial bank or broker on the secondary market, or through a donation;
- a conservation PVO must be interested in an environmental program within the debtor country; and it must have or obtain the necessary capital to purchase the debt, or secure a donation of debt;
- the debt must be trading at a secondary market discounted rate low enough for the conservation non-government organization to benefit more from the debt-for-nature swap than making a direct payment to the country;
- the debtor government central bank must approve the method, the rate of exchange in local currency, and the price at which it will agree to pay off the swapped debt—and the conservation [PVO] must accept these provisions;
- a local constituency must support the conservation project;
- a local non-government organization or government agency must be willing to assist in monitoring or managing the new conservation program.

Cody, *Debt-for-Nature Swaps in Developing Countries: An Overview of Recent Conservation Efforts*, Cong. Res. Serv. 1-2 (Sept. 26, 1988).

fectured by LDC loan defaults: environmental PVOs, the debtor LDC, and the lending institutions.

### 1. Benefit To PVOs

PVOs often provide the impetus for environmental conservation in debtor LDCs. While governments typically focus upon economic advancement, international and local PVOs ensure that environmental concerns are not forgotten. Additionally, PVOs may supervise and implement environmental programs within a country. Large international PVOs have played an integral role in the implementation of DFNs. For example, the World Wildlife Fund and Conservation International have provided funding, advice, and credibility to several DFN proposals. Local PVOs, such as *Fundacion Natura* in Ecuador, have also become heavily involved in promoting DFN projects within their own countries.

The DFN can enable a PVO to fund ambitious and costly environmental projects. For example, a PVO with \$500,000 for Costa Rican conservation projects could purchase Costa Rican debt on the secondary market, the price typically discounted to fifteen percent of the debt's face value. Pursuant to a conversion agreement, the PVO could cancel this hard currency debt in return for payment of the full face value of the debt in local currency at a favorable exchange rate. The PVO would be unconcerned with receiving hard currency because the swap proceeds would be used in Costa Rica. Thus, through a conversion a PVO can dramatically multiply its funds for use on conservation programs. In the example above, the PVO would have obtained \$500,000 in local currency at the official exchange rate had it simply purchased Costa Rican colones. However, through a DFN the PVO could buy \$3,335,000 of Costa Rican debt (valued at fifteen percent of face value), and then obtain \$3,335,000 worth of colones at a favorable exchange rate.

Utilizing even a small portion of the outstanding debt for conversions could provide a major increase in funding available for projects. Additional funding could permit the implementation of long-term agreements, enhancing the likelihood of success for more ambitious programs. For example, if a DFN enabled an LDC government to convert its hard currency debt to long-term bonds payable to the PVO in local currency, the interest payments from the bonds would constitute a steady flow of revenue and thus a long-term endowment for the project. Rather than struggling regularly for renewed funding, project managers could focus upon instituting and monitoring environmental programs.

Moreover, an LDC government's willingness to perform a debt conversion for the benefit of a PVO-initiated project demonstrates the government's support for the project. Such support in turn en-

courages PVOs to invest their time, money and energy for the long-term benefit of the host country. Usually, DFN projects are jointly sponsored by international PVOs (such as Conservation International) and local PVOs. The international PVO provides the funding and technical expertise, while the local PVO implements the specific project. A local PVO's knowledge of an LDC's specific needs benefits the LDC by ensuring local participation in economic, environmental and social reforms.<sup>20</sup>

## 2. Benefit to the Host Country

Massive foreign debt obligations take a drastic toll on LDC economies. Debt payments drain scarce supplies of hard currency, thus restricting critical imports of critical technologies and otherwise depleting funding for development projects. Perhaps the poor citizens of debtor nations suffer most grievously, because governments must pay international creditors with funds needed to create jobs, build housing, or fund park and recreation facilities.

In light of these problems, the DFN can benefit all sectors within the debtor nation. The DFN can help to ease the debt burden by reducing outstanding principal balances and hence lowering interest expenses. Further, conversions providing for repayment of LDC debt with local currency can ensure that recipients will reinvest the proceeds for local projects aiding conservation. Moreover, a lightened debt burden permits the softening of economic austerity programs and frees up funds necessary to remedy domestic problems even beyond conservation. Finally, an LDC can likely repay its adjusted debt more reliably, thus helping to upgrade its credit rating and thus attract new foreign investment and developmental funding.<sup>21</sup>

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20. While local PVOs are not ordinarily affiliated with the debtor government, some LDC governments have established organizations to guide environmental policy. This raises questions regarding the sponsored agency's true commitment to environmental conservation, and has created obstacles for international PVOs attempting to affiliate with local PVOs to implement projects. Comment, *supra* note 6, at 1075.

21. These advantages notwithstanding, the DFN is not appropriate in all situations. For example, assume that PVO X intends to invest in a \$10 million project in LDC Y. Through a DFN, X can purchase \$10 million of Y's debt on the secondary market for perhaps fifteen cents on the dollar, and then swap it with Y's government for \$10 million worth of bonds denominated in local currency. Consequently, X will have financed its \$10 million environmental project for only \$1.5 million. However, if X had been willing to invest \$10 million on the project without the conversion, Y has effectively subsidized X in the amount of \$8.5 million for a project X intended to pursue anyway. Although Y has benefited by the reduction of its foreign debt obligation, it could have used the debt conversion to provide incentives to investors more reluctant than X. Thus Y would have received X's contribution as well as funds from less enthusiastic investors. See Chew, *supra* note 13, at 12.

If the swap is "additional," meaning the investment would not have been made without the conversion mechanism, then it provides a benefit both to the LDC and to the investor who can undertake a project that would have been unavailable without the

Additionally, DFNs are a particularly attractive form of debt-for-development swap because foreign investors typically do not gain ownership control of any property in the debtor LDC. Instead, an international PVO will exchange the debt instrument to the benefit of a local conservation organization. With the help and guidance of the international PVO, the local PVO implements and monitors its own program. Thus, the DFN investment goes entirely for projects within the debtor country, not to the advantage or benefit of foreign entities participating in the transaction.<sup>22</sup>

### 3. Benefit to Lending Institutions

Creditors continue to suffer badly from LDC loans. Large amounts of risky LDC debt on a bank's balance sheet have reduced portfolio value and have required large provisions of loss reserves which cannot be used for profitable investment.<sup>23</sup> Therefore, the threat of default on LDC debt harms the creditor in at least two ways. First, the bank is unable to recover outstanding principal, much less receive interest revenue. Second, the bank cannot productively invest the loss reserves it must maintain. The debt conversion mechanism can strengthen bank portfolios by eliminating risky LDC debt from balance sheets, thus lowering required loss reserves and freeing funds for investment.

The DFN is not equivalent to debt forgiveness; DFN drafters recognized that forgiving the debt of one LDC could lead to other debtors requesting similar treatment, and thus strain creditor relations with frustrated debtors. Furthermore, forgiveness rewards debtors that default on obligations, thus providing a windfall against those that have made payments on schedule. The DFN provides a method by which LDCs may alleviate but not escape their debt burdens. Finally, the mechanism can be useful to streamline the debt renegotiation process by reducing the number of creditor banks.

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ability to leverage funds. A 1989 study of 101 debt-for-equity conversions in Argentina, Brazil, Chile, and Mexico demonstrated that one-third of the conversions resulted in investment by multilateral corporations that would have abstained without the conversion attraction. *Id.* at 13.

22. Cody, *supra* note 19, at 1-2.

23. Comment, *supra* note 6, at 1074. Acknowledging that LDCs might never repay a great deal of their debt, some banks began to recognize losses. In 1987 Citicorp started a trend among U.S. and foreign lending institutions by setting aside \$3 billion in loss reserves against its LDC portfolio. In June 1989 federal regulators instructed U.S. banks to classify Argentine loans as "value impaired," forcing the banks to establish reserve accounts and correspondingly to declare losses. In January 1990 federal regulators ordered banks to double the Argentine reserves in their fourth quarter reports. Prior to this order, eleven major U.S. banks had already set aside reserves to cover an average of sixty percent of their outstanding LDC debt. *Id.* at 1074.

## II. AID's Hesitant Involvement in DFN Transactions

Dr. Lovejoy proposed the DFN as a method to address environmental conservation issues in debtor LDCs without hindering development. This linkage between economic development and the environment accorded well with AID's operational mandate. In addition to economic support, Congress appropriated specific development assistance funds for AID to sue on environmental projects. For example, section 118(c)<sup>24</sup> of the Foreign Assistance Act directs AID, "[i]n providing assistance to developing countries, [to] . . . [p]lace a high priority on conservation and sustainable management of tropical forests," and to support various specific initiatives to improve forest management "to the fullest extent feasible."<sup>25</sup>

However, before becoming involved with DFNs, AID was forced to consider the political consequences of its prospective actions.<sup>26</sup> For example, AID's involvement in debt conversions would have an impact, however slight, on the debt of the participating LDC. Because the Treasury Department was involved in sensitive negotiations regarding the debt crisis, any AID action could be perceived as interference. Responding to these conflicts, Congress created legislation that defined AID's activities with regard to the Treasury Department's debt relief policies.

Careful not to intrude upon the Treasury Department's functional territory, AID was also restrained from acting in a manner not specifically approved by Congress. In particular, due to Congress' spending power, AID is compelled to use appropriated funds in a manner consistent with the legal principle that bars unauthorized "augmentation of appropriation."

By making an appropriation, Congress establishes an authorized program spending level. An agency spending beyond this level with funds derived from some other source usurps Congressional authority. Restated, the doctrine barring augmentation of appropriated funds prevents a government agency from subverting Congress' spending power by spending in excess of its authorized budget.<sup>27</sup> Hence, the augmentation principle applies to foreign

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24. 22 U.S.C. § 2151p-1 (1978).

25. *Id.* See also Foreign Assistance Act § 103(b)(3) which authorizes AID to provide assistance for "forest projects," with emphasis on "community woodlots, agroforestry, reforestation, protection of watershed forest, and more effective forest management." 22 U.S.C. § 2151a. Moreover, Foreign Assistance Act § 119(g) directs AID to "enter into long-term agreements in which the recipient country agrees to protect ecosystems or other wildlife habitats. . ." 22 U.S.C. § 2151q.

26. Conversation with Mr. Edward Hunnold, AID Attorney Advisor for Legislation and Policy (November 1990).

27. The Comptroller General has consistently applied the augmentation principle with respect to foreign aid. If the income earned on appropriated funds does not reflect the program's purpose, the augmentation rule applies and the earnings must be deposited with the Treasury Department. For example, the Controller General has held that

assistance appropriations when authorized funds are supplemented and used in a manner unintended by Congress.<sup>28</sup>

In a DFN, AID extends development assistance funds, authorized for conservation programs in LDCs, to PVOs for use in their environmental projects. However, the DFN transaction requires that the PVO use its AID grant to purchase discounted debt on the secondary market rather than fund a project directly. Pursuant to a prior agreement with the LDC, the PVO then would swap the purchased loan for a sum in local currency greater than the original AID grant. This excess of funds obtained through the DFN constitutes a violation of the augmentation principle. To state an example, Congress might appropriate \$100,000 to AID for tropical forest projects in Country X. Traditionally this money would be used directly to pay for project expenses in X. However, if the money is first used in a debt swap, the original \$100,000 appropriated by Congress will amount to \$185,000 or more (depending upon the terms of the deal). Thus, through the DFN the funds derived from the AID grant exceed the congressional authorization.

The legal impact of the augmentation principle is uncertain given that no cases have held that a debt conversion improperly has generated excessive funds. Regardless of legal status, however, AID's financing of DFNs at least theoretically infringes upon a zealously guarded congressional power. Hence, AID would have been political naive to become involved in DFNs without carefully considering the political impact of such involvement.

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AID subgrantees were barred from earning interest on revolving fund accounts, because the advance of funds to the subgrantees was not a "disbursement for grant purposes in the sense that allowable grant costs have been incurred." Matter of: Agency for International Development—Interest Earned by Subgrantees on Advanced Funding, 64 Comp. Gen. 96, 98 (1984). See also *To the Secretary of State*, 42 Comp. Gen. 289, 295 (1962) (barring establishment of endowment funds by foreign schools receiving assistance under the U.S.-sponsored schools abroad program); *To the Secretary of Agriculture*, 40 Comp. Gen. 81, 83 (1960) (requiring the Department of Agriculture to return interest paid by foreign banks on local currency deposits advanced to U.S. participants in cooperative agreements under Title I of the Food for Peace program).

28. This result may be mitigated when income earned from the funds relates to their appropriated purpose. For instance, in 1984 the Comptroller General held that the augmentation principle was not violated when local governments in Egypt, which were subgrantees of funds advanced by AID to the central government of Egypt, retained interest revenues earned on those funds. Matter of: Agency for International Development—Interest Earned on Grant Funds by Foreign Government, 64 Comp. Gen. 103 (1984). In this case the AID funds, which were available under the broad authority of the Economic Support Fund Program, were "for the purpose of providing grantees or subgrantees with experience in managing, handling, and by implication, investing project funds, including the right to earn and retain interest thereon." *Id.* Since the "material purpose" of the grant encompassed investment, and the grant funds had been disbursed before the interest was earned, the interest was program income. *Id.*

### III. AID's DFN INFRASTRUCTURE

Through a series of legislative acts and executive decisions, Congress and the Administration promoted AID's use of the DFN as a mechanism for debt relief and environmental conservation. Furthermore, the thrust of the DFN program gradually shifted from debt relief to environmental preservation.

#### A. IRS Ruling 87-124<sup>29</sup> Clears the Path for Banks to Donate LDC Debt to PVOs

In issuing IRS Ruling 87-124 in November 1987, the Treasury Department clarified the tax consequences of bank donations of LDC debt for development purposes. Inspired by Lovejoy's debt for nature proposal, the ruling was consistent with Secretary Baker's plan to resolve the debt crisis.<sup>30</sup>

By embracing the resolution, IRS Ruling 87-124 provided a potentially important incentive for lenders to participate in DFNs. Ordinarily, an entity which sells debt or other depreciated property and donates the proceeds can take a charitable tax deduction for the fair market value of the debt or depreciated property, and a loss deduction for the difference between the entity's basis in the debt and the debt's fair market value. However, prior to the ruling a creditor donating LDC debt would receive only a deduction equal to the debt's fair market value. Hence commercial banks were reluctant to donate LDC debt to international PVOs, because the banks received more favorable tax treatment by requiring payment.

IRS Ruling 87-124 attempted to eliminate this disincentive in the case of debt swaps. To illustrate, the ruling describes a U.S. commercial bank which transfers an LDC debt instrument to the LDC's central bank, which in turn credits the account of a U.S. PVO with an agreed amount of local currency. The PVO can use the local currency only for charitable purposes. For tax purposes the U.S. commercial bank is considered to have received the local currency directly from the central bank and then contributed these funds to the PVO. Accordingly, the U.S. bank can declare a deductible loss equal to the difference between its basis in the debt instrument and the instrument's fair market value. Additionally, the U.S. bank can claim a charitable deduction equal to the fair market value of the donated instrument. Thus, under IRS Ruling 87-124 a bank enjoys the same tax advantage by donating the LDC debt directly to the charitable organization as it would by selling the debt.

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29. Rev. Rul. 87-124, 1987-2 C.B. 206.

30. Letter from Secretary James A. Baker, III to Dr. Thomas E. Lovejoy (June 25, 1987).

In an effort to further clarify the ruling and satisfy inquiring Congressmen, Deputy Treasury Secretary McPherson wrote a letter to Senator John Chafee.<sup>31</sup> In the letter McPherson cited the Baker Plan to include "the conversion of LDC debt paper to local currency for use by charitable organizations as an item on the 'menu' of alternative techniques to expedite commercial bank financing packages." McPherson noted that IRS Ruling 87-124 was drafted to facilitate commercial bank donation of debt for such purposes, and explained that the ruling clarifies the "tax treatment of possible gains and losses" from debt swaps "as well as the donation of debt instruments to U.S. charitable organizations" for LDC development purposes. "It enables the donor to claim a tax deduction for the full face value of the claim." McPherson further stated that the purpose of the ruling was to both reduce debt burdens and promote conservation efforts.<sup>32</sup>

IRS Ruling 87-124 and McPherson's letter did not precipitate a flood of bank donations. However, the disappointment resulting from this tentative response was largely misplaced, in part attributable to the misperception that banks would receive a tax advantage from debt donations. To the contrary, rather than creating a new tax break for donating creditors, the ruling only eliminated creditor disincentives by treating equally for tax purposes losses from debt donations with those from debt sales.<sup>33</sup>

Banks remained wary of debt swaps for other reasons. For instance, some banks prefer to sell debt because, as one commentator noted, "even a charitable donation may raise shareholder fears of mismanagement and may prompt shareholder lawsuits."<sup>34</sup> Additionally, some banks had problems interpreting the ruling in the context of a deal. Moreover, Ruling 87-124 does not apply to U.S. bank donations to foreign-based PVOs. Hence, although a U.S. PVO can spend donated funds overseas and remain within the ruling's scope, the foreign PVO, locally based and thus more familiar with local conditions, perversely cannot qualify within the ruling.

In fact, the single instance to date of a debt-for-nature donation reflects the ambivalence of lenders towards the incentives offered by Ruling 87-124. Fleet/Norstar Financial Group, Inc. of Rhode Island donated \$250,000 of its Costa Rican debt to the Nature Conservancy, with funds from the exchange benefiting the Parque Nacional Braulio Carrillo. While it was reported that Fleet/Norstar was motivated by Ruling 87-124, the bank's senior vice-presi-

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31. Letter from M. Peter. McPherson to Senator John Chafee (Jan. 13, 1988).

32. *Id.*

33. Lamp, *A Tax Blueprint for LDC Debt-for-Development Swaps*, 39 TAX NOTES 1215, 1217 (1988).

34. Cody, *supra* note 19, at fn. 15.

dent stated that uncertainty about the ruling led the bank simply to write off its donation as a loss without regard to the ruling's incentives.<sup>35</sup>

Although Ruling 87-124 has not generated many bank donations, it has led to some benefits. Aside from demonstrating administration support for DFNs, the ruling has provided an incentive to LDCs to sponsor debt-for-nature programs in their countries, thus advancing Baker Plan objectives. For example, with an eye to tax exemptions for environmental donations available in the U.S., the Argentina National Development Bank announced a debt for nature swap program aimed largely at American lenders.<sup>36</sup> Banks may also discover that debt donations yield public relations benefits.

### B. Congress Urges Multilateral Banking Institutions to Promote DFNs

Pleased with the Administration's handling of the tax issue, in 1988 Congress turned its attention to the activities of multilateral lending institutions. The Continuing Appropriations Act for 1988<sup>37</sup> ("The Act") represented an overall attempt to promote multilateral development bank lending for environmental and natural resource conservation. The Act instructed the Treasury Department to encourage commitment by multilateral development banks to environmental and natural resource concerns, and required U.S. banks to include environmental impact studies for all country lending strategies. A subsequent Treasury Department report recommended a World Bank pilot project to provide technical assistance for debt-for-nature swaps.

Section 537(c) of the Act mandated consideration of strategies to purchase discounted debt in exchange for environmental commitments; to extend payment deadlines and reduce interest rates on outstanding debt, in return for local currency investments in conservation programs; and to establish World Bank and IMF programs for debt for nature swaps. Further, section 537(h) required AID to analyze the environmental and natural resource impact of intended projects and to share that information with interested donors and borrowing nations.<sup>38</sup>

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35. *Id.*

36. *National Development Bank Announces its Handling of Debt-for-Nature Bonds*, 13 Int'l Env'tl. Rep. (BNA) No. 2, at 64 (Feb. 14, 1990).

37. 22 U.S.C. § 2621.

38. J. Barnes, *New U.S. Legislation Concerning Multilateral Development Banks and the International Monetary Fund* (Feb. 28, 1988) (unpublished memorandum available from the Environmental Policy Institute).

### C. AID's Debt-for-Development Initiative

Responding to congressional interest in DFNs, AID issued its "Debt for Development Initiative"<sup>39</sup> in April 1988. According to the Debt for Development Initiative, AID must approve the terms of a proposed debt conversion receiving AID funding, including the sale price. Furthermore, funds obtained through an AID-sponsored debt exchange are to be used for a specified environmental program. Additionally, to avoid the appearance of debt forgiveness which might result from direct negotiations with debtor governments, AID must extend funds to non-government intermediaries, which technically would arrange the conversions directly with recipient governments. In this way, non-government organizations "will play a central role in the Debt for Development Initiative by serving as intermediaries . . . for the purpose of acquiring and retiring the debt. [The] organizations will then be responsible for managing the use of resources acquired through the debt exchange for development activities approved by AID."<sup>40</sup>

Congress demonstrated support for DFNs after the Guidelines were published by passing § 584 of the Foreign Operations, Export Financing, and Related Programs Appropriations Act of 1990.<sup>41</sup> Section 584 allows AID grantees to retain interest earnings from money received. This provides relief to DFN participants from the augmentation principle. For instance, DFN participants formerly were required to return excess earnings from AID funds to the Treasury Department. As a result of § 584, participants can retain and use these earnings in development projects. Helped by this legislation, AID's role in DFNs expanded significantly.

### D. Congress Passes the Global Environmental Protection Assistance Act of 1989,<sup>42</sup> Specifically Encouraging AID to Promote DFNs

After the positive reaction to AID's Debt-for-Development Guidelines, Congress passed legislation ensuring funding and support for AID DFN activities. The Global Environmental Protection Assistance Act ("the Environmental Protection Act") was perhaps the most comprehensive step. While insuring Congressional oversight of AID's activities, the Environmental Protection Act gives practical effect to the Debt for Development Initiative, extending AID's authority to foster environmental conservation.

In particular, the Environmental Protection Act provides spe-

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39. U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT, AID ANNOUNCES DEBT FOR DEVELOPMENT INITIATIVE (1990)

40. *Id.*, at 1-2.

41. Pub. L. No. 101-167, § 584, 103 Stat. 1251, 1252 (1989).

42. 22 U.S.C. §§ 2281-2286.

cific authority and detailed guidelines for the administration of the DFN program, especially in Sub-Saharan Africa.<sup>43</sup> Significantly, the Environmental Protection Act establishes statutory authority for DFN grantees to retain interest on the proceeds of debt exchanges and to establish endowments with these proceeds.<sup>44</sup>

Furthermore, the Environmental Protection Act empowers AID to take the initiative in developing DFN projects. It authorizes AID to "identify those areas . . . in particular need of immediate attention to prevent the loss of unique biological life or valuable ecosystem[s,]" and "to encourage" DFNs in order to "demonstrate . . . the feasibility and benefits of sustainable development."<sup>45</sup>

Specifically, the Environmental Protection Act authorizes AID to provide grant assistance to PVOs to purchase discounted commercial LDC debt for DFNs. In order to receive such funds, the LDC must be "fully committed" to the long-term viability of the nature project; must prepare a long-term plan; and must designate a governmental or non-governmental organization to oversee the project.<sup>46</sup> Congress defines the particular environmental areas that may be addressed through programs funded by the Environmental Protection Act. These areas include natural resource management, conservation training, and air and water protection.<sup>47</sup>

Finally, the Environmental Protection Act establishes a pilot project in Sub-Saharan Africa. It authorizes AID to "invite [each Sub-Saharan African] government . . . to submit a list of those areas of severely degraded national resources which threaten human survival and well-being . . . , or those areas of biological or ecological importance within the territory of that country". Based on the lists, AID would "seek to reach agreement" with each country concerning the "restoration and future sustainable use of those areas."<sup>48</sup>

The Environmental Protection Act establishes AID's central role in the DFN. While legislators claim that "AID does not negotiate transactions or enforce agreements among parties involved in a debt conversion,"<sup>49</sup> the Environmental Protection Act provides a method by which AID controls the use of funds derived from debt conversions. For instance, AID audits the use of funds received from the debt conversion mechanism; approves amendments to agreements establishing debt conversions; and controls funds in the event of termination, changes, or waivers of conversion agreements.

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43. 22 U.S.C. § 2286.

44. 22 U.S.C. § 2282.

45. 22 U.S.C. § 2283.

46. 22 U.S.C. § 2284.

47. 22 U.S.C. § 2283.

48. 22 U.S.C. 2286.

49. DDC GUIDE, *supra* note 7, at 5.

Thus, AID has virtual veto power over any DFN funds granted.<sup>50</sup>

Although retaining control over the ultimate use of its funds, AID is not a direct party to any DFN. As stated above, AID funds and oversees each DFN transaction while delegating the management and implementation to the participants. AID's limited role may address criticism of U.S. government infringement upon host country sovereignty. Further responding to host nation sovereignty concerns, the Environmental Protection Act allows local governmental organizations to oversee the use of converted debt. This shows an increased sensitivity to LDC concerns not exhibited under the Debt for Development Initiative, which offered limited opportunities for LDC government oversight.

Somewhat controversially, the Environmental Protection Act does not address the role of local environmental councils. Many LDC governments have established environmental councils to oversee national conservation concerns. These councils promote short-term economic development over long-term environmental conservation. Brazil's proposed environmental council, for instance, would report directly to the president and would have no non-governmental representatives, thus drawing criticism from local environmental organizations.<sup>51</sup> While the Debt for Development Initiative specified that intermediaries will not be "instruments of the aid-recipient country's government,"<sup>52</sup> the Environmental Protection Act does not maintain the same restriction. Therefore, AID

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50. This veto power addresses fears that A.I.D. may lack the power to perform its monitoring duty.

The issue of AID's control over its grantees is an old one. For example, according to Office of Management and Budget ("OMB") rules, a grantee cannot receive AID funds more than ninety days in advance of the expected expenditure. This provision reflects OMB's general desire to maintain control of how government funds are used by grantees. However, for DFN transactions the OMB applied the ninety day rule permissively, deciding that the expenditure of funds occurs at the time the debt is purchased, not when the AID-approved project begins. Interview with Gerald Wein, Vice-President, Debt-for-Development Coalition (Dec. 4, 1990) [hereinafter Wein Interview].

OMB's rationale for its relaxed treatment of DFN participants resembles the augmentation principle analysis applied to DFNs. While normally the appropriated funds would be placed in a trust fund until needed for expenditure to comply with augmentation principle requirements, OMB and AID have circumvented this rule by claiming that the appropriation, for accounting purposes, goes toward the debt purchase. After the conversion transaction, title to the funds belongs to the PVO.

While AID's Inspector General criticizes AID's lax supervision of grant recipients, AID contracting officers claim that their oversight is effective and that the good relationship maintained with grantees helps insure that funds will be properly used. Additionally, AID supporters note that providing grantees with title to funding promotes local autonomy, thus curbing claims of U.S. imperialism, patronism, and subversion of sovereignty.

51. *Brazilian Congressman Criticizes Plan of President for Protecting Amazon Forest*, 12 Int'l Env'tl. Rep. (BNA) No. 5, at 234 (May 10, 1989).

52. U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT, *supra* note 39, at 7.

must consider the political affiliation of a potential overseer and its connection to the organization to be supervised.

To conclude, while AID drafted the Debt for Development Initiative under the guise of providing a source of debt relief, the Environmental Protection Act firmly defines AID's role in promoting environmental protection through DFNs. In this legislation, debt conversion is treated as a mechanism to advance further environmental concerns. Hence, the Environmental Protection Act advances the congressional mandate that AID's debt reduction activities focus upon environmental conservation.

#### E. The Debt for Development Coalition and Foundation

Both the Debt for Development Initiative and the Environmental Protection Act established AID as a funder of debt conversions. However, the relatively new debt conversion process and the complicated financial measures necessary to accomplish a DFN deterred many potential parties. In response, in September 1988 AID's Bureau for Policy and Program Coordination established the Debt for Development Coalition ("the Coalition") to simplify the process. The Coalition compiled and disseminated information to interested entities, gave project advice and promoted debt conversions. While many groups were instrumental in the Coalition's formation, AID provided the main source of funding for the Coalition, and the staff was comprised of employees "directly hired from AID."<sup>53</sup> Further, although working predominantly with U.S. PVOs, the Coalition coordinated its activities closely with foreign PVOs and non-governmental organizations. For example, a workshop in Ecuador aided local groups which had contacted the Coalition for help and advice.<sup>54</sup>

In its involvement with debt conversions, AID had identified informational services and operational advice as distinct functional divisions. First, AID wanted to inform LDC governments and PVOs about available debt conversion options. Second, after deciding upon an option, PVOs needed technical advice on making the debt conversion work. Eventually Coalition officials decided to separate the two functions, largely because lobbying for debt conversions endangered the Coalition's non-profit status. Consequently, the AID directors divided the Coalition into two separate entities: the Coalition and the Foundation.<sup>55</sup>

As divided, the Coalition "is intended to serve informational

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53. Wein Interview, *supra* note 50.

54. *Id.*

55. U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT, MEMORANDUM OF UNDERSTANDING BETWEEN THE DEBT-FOR-DEVELOPMENT COALITION, INC. AND THE DEBT-FOR-DEVELOPMENT FOUNDATION (1989).

and educational purposes for not-for-profit organizations engaged in international development activities. The Coalition will promote the concept of debt-for-development before private and public bodies and intends to create a national advisory board of prominent individuals for advancing debt-for-development."<sup>56</sup> On the other hand, the Foundation "shall serve as an operational entity for the purpose of undertaking debt-for-development transactions on behalf of itself and/or other not-for-profit entities in the United States and abroad."<sup>57</sup>

Although theoretically distinct with unambiguous charters, the precise roles and proper functions of the two divisions remain unclear. This problem results partially from the sharing of facilities between the two groups, a circumstance somewhat necessitated by a lack of funding. Further, more substantive functional controversies persist. For instance, the Coalition often acts as a "match maker" to potential debt conversion parties.<sup>58</sup> When interested PVOs present sufficiently comprehensive plans, the Coalition creates partnerships and searches for sources of funding. Some staffers assert that this match maker role improperly conflicts with the Coalition's core educational mandate.<sup>59</sup>

Despite these difficulties, AID has achieved some success through its revised debt conversion structure. For instance, the Fundacion Natura in Ecuador, a project created through Coalition funding and Foundation technical advice, demonstrates the potential effectiveness of the two divisions.<sup>60</sup> The Coalition introduced the DFN concept to Ecuador, a nation in which environmental conservation efforts were hampered by lack of funding. The Foundation helped to establish the Fundacion Natura, an autonomous Ecuadorian environmental organization.<sup>61</sup> Fundacion Natura has led several debt-for-nature swaps, and now oversees the preservation of Ecuador's environment.

F. Congress Passes the Enterprise for the Americas Initiative, Giving the Treasury Department Authority Over LDC Debt Matters, and Directing AID to Address Environmental Issues<sup>62</sup>

On June 27, 1990 President Bush introduced the Enterprise for the Americas Initiative ("the Initiative"), an ambitious measure

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56. *Id.*, at 3.

57. *Id.*

58. Wein Interview, *supra* note 50.

59. *Id.*

60. *Id.*

61. *Id.*

62. Pub. L. No. 101-624, 1990 U.S. CODE CONG. & ADMIN. NEWS (104 Stat.) 3658 (to be codified at 7 U.S.C. § 1738).

aimed at western LDCs. Notably, the Initiative represents a shift in U.S. policy from forgiving LDC debt in some cases<sup>63</sup> to accepting partial repayment of debt from Latin American and Caribbean countries owed under the Food for Peace, EXIM Bank and Commodity Credit Corporation programs.<sup>64</sup> This comment focuses on the debt aspect of the Initiative, particularly its guidelines designed to make additional resources available for environmental protection and investment.

The portion of the Initiative signed into law the first week of December 1990 authorizes the Treasury Department to establish a "Enterprise for the Americas Facility" to reduce Food for Peace program debt owed to the U.S. by Latin American and Caribbean LDCs.<sup>65</sup> Included in the rescheduled debt agreement will be the creation of "environment funds" in participating countries. Interest payments made on the debt will be diverted to these environment funds, which will support environmental programs in the debtor countries.<sup>66</sup> The debtor country will be obligated to pay local currency instead of hard currency into the environment fund, thus alleviating the debt burden. Although a PVO will manage the environment fund's operations, an administrative body composed of U.S. government, host country government, and PVO representatives will make policy decisions concerning how the environment fund should be employed.<sup>67</sup>

The debt restructuring portion of the Initiative presents issues that must be addressed in the future. For instance, the Initiative gives authority to the Treasury Department to reschedule Latin

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63. For example, the U.S. has forgiven \$825 million of public debt owed by fourteen Sub-Saharan African countries, but has not forgiven debt owed by severely impoverished Haiti and Bangladesh.

64. THE DEBT-FOR-DEVELOPMENT FOUNDATION, DISCUSSION PAPER: THE ENTERPRISE FOR THE AMERICAS PROGRAM: IMPLICATION FOR THE NON PROFIT COMMUNITY 2 (1990).

65. Enterprise for the Americas Initiative, § 601. In such a restructuring the Treasury loses the revenue expected from loan in the year of conversion. Statement by Geoffrey S. Barnard, Vice President for the Nature Conservancy, Before the Subcommittee on Western Hemisphere Affairs and the Subcommittee on Human Rights and International Organizations, Committee on Foreign Affairs, U.S. House of Representatives, at 6 (July 11, 1990) [hereinafter Barnard Statement].

66. Section 607 authorizes the President to enter into an "environmental framework agreement with eligible countries" which "requires the eligible country to establish an Environment Fund . . . to make interest payments . . . into the Environment Fund; and requires the eligible country to make prompt disbursements from the Environment Fund to [a representative body administering the use of such funds]. . . ." Enterprise for the Americas Initiative, § 607.

67. The purpose of the body will be to issue grants and to oversee and manage grant activities. The Fund "shall give priority to projects that are run by [PVOs] and other private entities, and that involve local communities in their planning and execution." The PVO running the Fund will be subject to annual audits, board reviews and reports. Any grant over \$100,000 is subject to a U.S. veto. *Id.*

American and Food for Peace debt. However, the Initiative empowers AID, not the Treasury Department, to implement the Food for Peace program and to establish environment funds in participating countries. Also, in October 1990 the House of Representatives authorized the reduction of AID debt in the same manner as the Food for Peace debt. Although the Senate has not acted on this measure, with the Administration's support the proposal is expected to become law.

The Initiative continues AID's evolution as a catalyst for DFNs. For example, the environment funds established by the Initiative help AID to promote DFNs. Furthermore, AID can offer debt rescheduling in return for a commitment to pay interest in local currency into an environment fund.

In addition, the Initiative places the Treasury Department in charge of debt conversions, thereby formally screening off AID from considering the implications of swap activities on the LDC debt situation. Thus, Congress insures that AID will focus upon the environmental aspects of the DFN.

AID's focus upon environmental aspects of the debt crisis has attracted the support of international environmental organizations. Many of these groups feel that with increased and more reliable access to DFN funding resulting from the Initiative, local environmental groups can better plan their efforts and also reduce their need for emergency international assistance.<sup>68</sup> Similarly, Conservation International describes how AID can help provide LDC environmental groups with the necessary financial and technical resources to transform designated areas from mere "paper parks" into effectively managed preserves.<sup>69</sup>

#### IV. AID'S EVOLUTION AS DFN CATALYST

In its growing focus upon environmental protection, increasingly AID has developed an effective network to promote, facilitate and implement DFNs. AID's evolving role as DFN catalyst is appropriate. By promoting DFNs, AID helps developing countries to organize their economies in a way that not only benefits development, but enhances environmental awareness and quality.

AID's catalytic role, which began with the organization's participation in the first DFN transaction, grew largely from the need of LDC debtors for development funding. By 1987, many LDCs recognized a link between environmental protection and sustained development. However, LDC governments were often politically constrained from sacrificing tangible short-term growth by channel-

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68. Barnard Statement, *supra* note 65.

69. *Id.*, at 3.

ing scarce funds into environmental programs. Further, at that time the DFN remained an untested financing option for environmental projects.

Against this background, in retrospect AID's efforts in the 1987 Bolivian DFN thus constituted a watershed. In this transaction the Bolivian government agreed to provide the maximum level of protection available to the Beni Biosphere Reserve, and also set aside for conservation an additional 3.7 million acres surrounding the Reserve. In addition, the government agreed to create the Inter-Institutional Technical Commission to manage the Reserve's large forest stocks of mahogany, jacaranda, and tropical cedar trees.<sup>70</sup> In return for these efforts, the Bolivian government received credits reducing its foreign debt by \$650,000. These credits were purchased on the secondary market by Conservation International for \$100,000.<sup>71</sup> Moreover, AID provided \$150,000 of the \$250,000 the Bolivian government committed to the establishment of the Inter-Institutional Technical Commission.

Largely as a result of AID's uncertain legal authority at that time to fund such transactions by intermediaries, Conservation International completed the debt conversion without AID's financial help. Reflecting its restricted role, AID followed customary procedure in providing development funds in response to the Bolivian government's project proposal.

However, its activities in the Bolivian deal established a new and enduring focus in AID's development efforts. AID's grant had the dual purpose of funding environmental conservation while alleviating a small portion of the Bolivian debt. The grant allowed Bolivia to allocate funds to a vital environmental project. Without AID's assistance Bolivia may not have been able to protect the Reserve adequately. Hence AID's grant provided both financial and psychological incentive to the Bolivian government to perform the first DFN.

AID's indirect, psychological assistance of DFNs gradually became less necessary. Recognizing the benefits of alleviating debt burdens while conserving foreign exchange reserves, LDC governments permitted debt conversions in growing numbers. Additionally, as the conversions became more sophisticated, participants learned that trading the debt for local currency bonds could enable projects to establish endowments funded by the interest generated from the bonds. Consequently, governments no longer relied upon AID grants to subsidize<sup>9</sup> the costs of environment programs. As such, the Bolivian transaction precipitated a surge of privately

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70. Gibson & Curtis, *supra* note 15, at 354.

71. This is a relatively small debt conversion when compared to subsequent transactions.

funded DFNs. These deals demonstrated that the DFN mechanism facilitates the funding and supervision of environmental projects without the constant need for new financing. Nonetheless, a debt purchaser in a DFN requires large sums of money that few non-governmental organizations have at their disposal. In fact, even relatively well funded organizations would likely not have enough money for a single deal. AID gradually filled this vital need for DFN financing.

Granting to PVOs the funds necessary to purchase LDC debt remains AID's most critical function as DFN catalyst. This arrangement suits AID because it insures that funds go directly to projects it supports, but does not require extensive AID oversight because activities will be tailored by the specific environmental interests of the groups involved.

In addition to providing funding for DFNs, AID has responded to other needs of DFN participants. For instance, PVOs require technical proficiency to perform a debt conversion, as well as organizational expertise to apply funds obtained to the intended project. While large international conservation groups such as the World Wildlife Fund and Conservation International have special branches to address the DFN mechanism, these organizations are exceptions. Primarily AID-funded, the Debt For Development Coalition and Foundation help PVOs resolve these issues. They provide educational programs to PVOs worldwide and also technical counseling in support of environmental programs already undertaken. Thus the Coalition and Foundation seek to enable PVOs to profit from the DFN.

However, AID's catalytic role extends beyond funding intermediaries and providing educational and technical advice. Environment funds created by the Initiative and the Environmental Protection Act Sub-Saharan countries project provide AID with additional tools to promote DFNs and to hence establish a permanent framework for environmental preservation. If, as expected, Congress authorizes the conversion of AID-owned LDC debt to fund environment funds, AID likely will increase its involvement in DFNs.

## V. CONCLUSION

AID's assumption of its role as DFN catalyst has come a long way. Initially AID emphasized the alleviation of debt in its development policy. Furthermore, at that time environmental conservation was perceived as an issue distinct from LDC debt relief. However, Congress reshaped and sharpened AID's function in addressing the debt crisis. It invested the Treasury Department with oversight and management authority in the Enterprise for the

Americas Initiative, while redirecting AID's debt relief focus towards the environment. Thus, Congress established that the Treasury Department would oversee the government's treatment of the LDC debt crisis, and that AID would concentrate upon environment conservation through its promotion and facilitation of DFNs. Consequently, AID's Congressional mandate for its DFN activities has firmly shifted from debt alleviation to the environment.

Ironically, the environmental benefits offered by DFNs provide a stronger basis for AID's activities than does debt alleviation. Most observers would agree that DFNs provide no "panacea" to the international debt crisis and actually account for an extremely small portion of LDC debt. In fact, the secondary market trades only about one percent of third world debt.<sup>72</sup> African and Asian sovereign debt (constituting the major portion of debt in those countries) is particularly unavailable for purchase on the secondary market. Although funds provided by DFNs provide incentive to LDCs to improve environmental preservation efforts, DFNs have had a minimal impact on the overall debt crisis. Nonetheless, "[u]nless some . . . innovative approaches to the debt crisis are tried, there will be no progress in such areas as conservation, education and health. . . . Innovative approaches such as the one suggested here will help protect our natural resources while helping to build a more stable economic system."<sup>73</sup>

The doctrinal shift from debt to environment in its DFN role impacts upon AID's overall activities. For example, environmental conservation, no longer criticized as a hindrance to development efforts, is now firmly grounded as one of AID's major concerns. As such, AID carefully weighs environmental considerations when formulating long-term development projects. The DFN concept has proven not only that development and the environment can be compatible partners, but also that in many ways environmental protection is synonymous with economic development. Demonstrating a sincere resolve to preserve its environment strengthens an LDC's efforts for economic prosperity. Environmental preservation efforts often do not win domestic political support, especially when competing with projects for short-term growth. However, a viable conservation program may convince international lending institutions that an LDC government is willing to sacrifice immediate political rewards in order to enhance long-term stability.<sup>74</sup>

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72. Cody, *supra* note 19, at Summary.

73. Umana, *Costa Rica's Debt-for-Nature Swaps Come of Age*, Wall St. J., May 26, 1989, at A11, col. 3.

74. Banks do not donate debt or make debt available for altruistic reasons, but they have "a big stake in rational, environmentally sound development" in LDCs. Richard L. Hiber, Citicorp Investment Bank, Presentation before the New York Rainforest Alliance 8 (October 16, 1987).