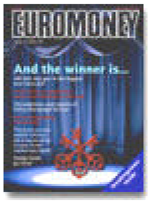
Euromoney May 2003



Iraq

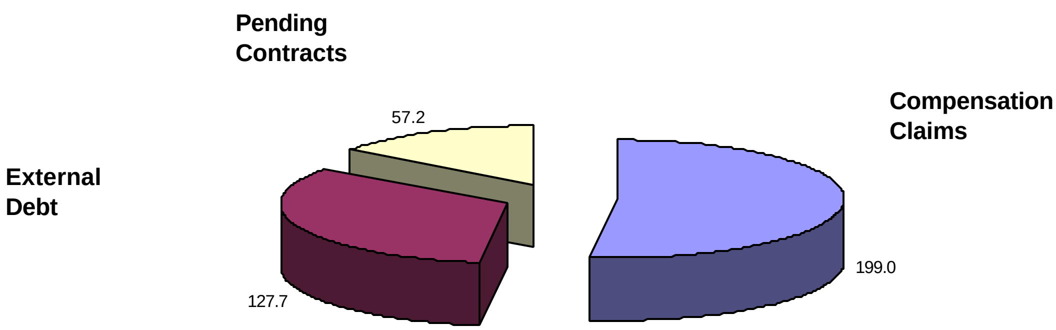
The mother of all debt restructurings

A restructuring of Iraq's financial obligations is arguably the most important initiative that must be undertaken in that country next to the provision of urgent humanitarian assistance.

Iraq's current liability profile shows that it has outstanding obligations of about $383 billion. This includes $199 billion in compensation claims received by the United Nations Compensation Commission (UNCC) in the aftermath of the first Gulf War as well as external debt and pending contracts.
Iraq's external debt is estimated variously at between $62 billion and $130 billion. The differential principally relates to a disagreement over the amount of assistance given by Gulf states to Iraq during the Iran-Iraq war and whether accrued but unpaid debt interest is included or excluded.

Finally, in the run-up to Operation Iraqi Freedom and earlier, the Iraqi administration entered into several infrastructure contracts with public and private foreign companies to the tune of $57.2 billion. The liability total of $383 billion must be measured against the asset side of the ledger, where it can be shown that Iraq has no meaningful source of financial liquidity resources under its control.

Current Iraqi Government Liability Profile
(USD Billions)



At a minimum, Iraq's net financial liability profile will prevent any new funds and resources being made available for reconstruction and the rebuilding of the country.
To put this into perspective we have calculated some debt ratios commonly applied by the World Bank and the IMF in assessing the health of borrower countries and their eligibility for debt forgiveness, humanitarian aid and other forms of assistance. Countries in the worst financial shape

are termed HIPCs (highly indebted poor countries). Although the World Bank and IMF maintain different threshold ratios for sustainable debt management, it is generally acknowledged that the maximum sustainable debt service to export threshold is in the range of 15% to 20%.

Debt Indicators
(per cent)

Sovereign Debt Ratios	Developed Countries (1)	39 HIPC Average (2)	Estimates for Iraq (3)
NPV of Debt to Exports	133	249	1751
NPV of Debt to GDP Ratio	38	84	672
Debt Service to Exports	20	14	351

Source: IMF/IBRD for (1) & (2). (3) derived from CSIS and middleeast.com data combined with the author's calculations

The table shows that among the HIPC countries this ratio is around 14%. In the case of Iraq the number is 351% or about 17 times worse than the sustainability threshold. The other indicators show a similarly alarming profile. These magnitude of these obligations underscores the magnitude of the pressure that, even excluding the UN sanctions, was being applied to Saddam's regime in the aftermath of the First Gulf War

Iraq now requires a comprehensive debt restructuring to ensure the long-term financial viability of its economy. There are three key elements to this process.

(1)Pressing decisions need to be taken on the role of foreign firms in the Iraqi economy, the legal basis for new contractual arrangements, possible privatization of certain government services, the refurbishment and rebuilding of oil production infrastructure and the refinancing of the economy. To do this a sound administrative and legal framework to give effect to all financial negotiations and decisions must be established. Because of the attenuated nature of Iraq's debt profile, and the urgent need for assistance and reconstruction, this body should possibly consider the establishment and implementation of a comprehensive sovereign bankruptcy framework for Iraq.

(2)A debt-restructuring plan that incorporates a review of all past war-related claims against Iraq must be devised and implemented. This will by necessity involve negotiations with multilateral bodies as well as groups of debtors' representatives. The debt plan should aim to stabilize the debt profile, shore up Iraq's liquidity position and position the country to begin reconstruction. At a minimum this should enable Iraq to move comfortably under the HIPC thresholds after taking into account the impact of the restructuring and the new borrowing required for reconstruction. The unsettled compensation claims to corporations, governments and institutions will likely be written down to zero. Negotiations between the Office of Reconstruction & Humanitarian Assistance – led by general Jay Garner, reporting to general Tommy Franks – and the UNCC on this point will presumably begin soon. It is expected that settled claims will be honored 100%. In all probability pending contracts will be cancelled. These deals may very likely not have been in the best interests of the Iraqi people as they seem to have been driven by the private interests of the Iraqi officials involved, and by the regime's efforts to buy votes at the UN and forestall invasion.

(3) Finally OHRA will most probably begin negotiations leading to a moratorium or rescheduling of external debt. A forgiveness of accrued interest and a five-year moratorium on any repayments of the external debt will result in the NPV of these obligations falling to about 25% to 30% of face value, a substantial and much needed adjustment. [The market appears to already have anticipated this.

Obligations that last fall were trading in the range on 8-10 per cent of face value rallied to 15 per cent as hostilities began, and in the last week of April reportedly traded at up to 25 per cent of par motivated by specialty fund purchases.]

For Iraq, the effect of the restructuring would be to devalue the debt portfolio by 85% to 90%. – about the norm in most corporate bankruptcies – and thus create the headroom needed to enable the Iraqi administration to borrow up to $100 billion of reconstruction finance over the next three to five years.

The big losers from this arrangement would be the creditor countries of (and/or companies in) France, certain Gulf States and Russia.

A new debt management programme must be established that gives the Iraqi government access to the funds that it needs to begin the process or reconstruction, yet provides new lenders with the comfort of knowing that their investment is safe.

This must involve the creation of a new borrowing structure that secures the borrowers' interest against a tangible and liquid reference asset.

The latter is something that Iraq has in abundance – oil. Securitized bonds could be structured and sold using the proceeds of oil sales as collateral. Should additional comfort be required to assure acceptance and liquidity a sovereign guarantee could be attached to the bonds that would protect the lenders in that case of default or non-performance by the Iraqi administration.
The appeal of the securitization alternative lies in the fact that it provides Iraq's new financial managers with a shock absorber against the impact of currency and interest rate fluctuations on its debt servicing profile. In addition, a large amount of borrowing could be supported by a relatively small fraction of Iraq's oil production. For example, depending on oil prices, securitization costs and whether or not a guarantee over the bonds were to be extended, $10 billion could be borrowed against as little as eight days' production at current rates of output.

There is no question that a massive financial restructuring of the Iraqi economy is needed. A plan similar to the one speculated on in this article will likely be implemented because the country is bankrupt.

Despite the magnitude of the recommended debt write-downs, creditors will feel minimal impact – although they may scream loudly – because the precepts of prudential financial management and observed market levels for the existing debt suggest that most of them should be carrying their Iraqi assets valued at market levels.

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