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Debt for Nonproliferation

A Concept Development Proposal for the Design and Operation of a Russia Nonproliferation Fund

James L. Fuller
Jana G. Fankhauser
Patricia Godoy-Kain
K. Mark Leek

January 2002

Prepared for
The Nuclear Threat Initiative
Under Agreement No. 6004, pursuant to
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Battelle--Pacific Northwest Division
Richland, Washington 99352

Debt for Nonproliferation
NTI Concept Development Proposal

Summary of Findings and Recommendations

This report documents the studies and analyses conducted on behalf of the Nuclear Threat Initiative (NTI) by Battelle, Pacific Northwest Division staff employed at the Pacific Northwest National Laboratory (PNNL), Richland, WA, on the concept of *debt for nonproliferation*. The period of performance of this work was July 2001 to January 2002. The fundamental premise is that, just as debt for nature swaps between wealthier creditor nations and developing debtor nations have been used as innovative financing mechanisms for solving pressing environmental problems, debt swaps should be adapted to Russian proliferation prevention problems. The purpose of this concept development proposal is to explore debt instrument availability, study the construct and operations of successful debt swaps and cooperative Russian programs for lessons-learned, provide a recommended construct for a Russia Nonproliferation Fund, and provide recommendations to NTI about the path forward. Battelle utilized the services of a Russian legal firm (Coudert Brothers), and a Russian economic analysis NGO (Institute for Private Sector and Socio-Economic Analysis) in the completion of this effort.

The economy of Russia has been relatively strong over the past 18 months. Foreign hard currency reserves are high. This is due primarily to the strong price of oil and gas on the world market during much of this period, the London Club debt reduction initiative in August 2000, and the success of the Putin Administration policies in moving toward a market economy. Total Russian external debt is approximately $147bn, with about $45bn being Paris Club debt, and $65bn being commercial debt with about $21bn of that being London Club restructured debt. About $71bn of total Russian external debt is old debt from the Soviet era. There are some special classes of Russian debt not included in these totals that may also prove to be of relevance.

The London Club restructuring of older Russian commercial debt in August 2000 transformed a portion of the Russian debt paper to Eurobonds. These instruments have an active secondary market and are currently seen as a good investment due to the perceived health of the Russian economy. Germany, which owns some 48% of Russia's Paris Club Soviet-era debt will set the tone for any future Paris Club-Russian debt negotiations. However, the FRG has stated that the Russian Federation should be able to service its debt with improved economic performance, a better use of natural resources, and a return of flight capital. No Paris Club restructuring activities are likely in the near future. However, Russian economic health is closely tied to oil prices, which have dropped by almost 40% in the last 6 months, making the situation somewhat volatile.

A promising special class of debt that could possibly lead to a debt for nonproliferation swap is German GDR debt. This is older Soviet Union debt to the German Democratic Republic that transferred to the Russian Federation and the Federal Republic of Germany, valued at $6.4bn by the FRG. This debt has been the subject of on-going negotiations between the two countries and should be pursued as a potential source of funding for debt for nonproliferation. It is not a component of the German federal budget, and will in all likelihood be settled under a swap agreement for the entire amount. Settlement is more motivated by political considerations than financial ones.

The United States Congress has on three occasions passed special legislation to forgive large amounts of debt, all three for security-related, i.e., political, considerations (Poland, Egypt, and Jordan) totaling over $10bn. One of these initiatives included a debt for environment swap (Poland). The U.S. Senate in December, 2001 unanimously approved in both committee (Foreign Relations) and on the chamber floor, a measure to extend this concept to Russia: S 1803, Title III, The Debt Reduction for Nonproliferation Act of 2001(DRNA). Even though the normal financial motivations for Russian debt swaps are currently low, political motivations after September 11th, and for other reasons, are strong. The opportunity exists for the United Sates under expanded provisions of the DRNA to leverage less than the $3bn in the Soviet-era debt it holds into an amount several times that by partnering with the FRG and utilizing the GDR debt. Additional leverage would result if the U.S. and Germany as a team, approach the remaining G-8 members and other official creditors. The Credit Reform Act of 1990 provides a mechanism for a private organization such as NTI to become involved. There may also be an opportunity for NTI to pursue the use of Russian regional debt, though this opportunity was not researched in any detail in the preparation of this report.

The are basically four mechanisms that may be used to effect debt swaps:

- **Buy-Back**. A debtor nation, after a negotiation, purchases debt directly from a creditor at less than face value, and at the same time underwrites a fund in local currency to conduct work in the debtor country that is of value to both the creditor and the debtor.

- **Write-Off**. A creditor agrees to just forgive some portion or all of an outstanding debt in exchange for the establishment by the debtor of the fund as described above.

- **Rescheduling**. Creditors agree to reschedule the servicing of old debt by exchanging a large amount of paper for a smaller amount. In the case of official bilateral debt rescheduling, some portion, such as the interest payments, are redirected into a swap fund. In the case of commercial debt, principal and interest are often separated into derivatives, which can be used separately.

- **Tri-Partite Arrangements**. A third party such as an international non-governmental organization receives a donation and/or purchases paper from a creditor and negotiates a write-off with the debtor nation.

NTI direct engagement in debt swaps would basically be described by the tripartite mechanism. In this, the creditors from whom NTI could buy or receive debt paper could be the U.S. Government (pursuant to the Credit Reform Act of 1990), a U.S. private financial institution or even an individual, and depending on the laws of the foreign country involved, the same types of foreign creditors.

The salient design characteristic of debt swap funds is the way they are established to distribute proceeds of a debt swap. Funds are typically established around one of three constructs, or utilize some combination of the three. These are:

- **Endowments**. An endowment allows only capital on income from investments to be used to finance a fund's activities. The principal remains intact.

- **Sinking funds**. Sinking funds allow both principal and investment income to be used to finance a fund's activities. Typically the entire principal is invested over a fixed period of time. When the money is gone, the fund expires.

- **Revolving funds.** Revolving funds accumulate principal on a regular basis through receipt of new revenues, such as income from fees or special taxes. Both principal and income are used to fund projects over a more indefinite period of time.

The choice of the construct depends on the goals of the fund. Endowments are useful when goals are long-term, investments are modest, and capacity building is a priority. Sinking funds are useful when projects have a definite end date or finite objective, such as property acquisition or capital construction. When revolving funds are structured around loans or receive incremental deposits they too can become a long-term financing mechanism, supporting indigenous capacity building.

A debt swap *fund* (or synonymously, *foundation*) is the recognized institutional mechanism for managing and distributing the proceeds of a debt swap to projects. **For the case of debt for nonproliferation swaps, it is recommended that a not-for-profit Russian entity, the Russia Nonproliferation Fund be established.** A potential problem in establishing a Russian fund is that funds have been abused in Russia for tax evasion schemes. However, Russian law provides for the founding of trustworthy and accountable charitable funds.

An effective structure for Fund asset protection involves four elements: a creditor-debtor framework agreement, a debt agreement, program management and project management. The isolation of the nuclear, chemical, and biological weapons complexes from the Russian reform process will make the need for proper tracking mechanisms for project monitoring all the more important.

Debt swap funds typically incorporate one-tiered or two-tiered management structures. It is recommended that a modified two-tiered structure with a Board of Directors and an Implementation Team be used for the Russia Nonproliferation Fund. To be successful and to serve multiple obligations and purposes, the Russia Nonproliferation Fund must be based on a partnership where decision-making is authentically shared, where there is efficiency and effectiveness in management and operations, and where there is full accountability in Fund allocations and project performance. For specifically these reasons, the authors recommend an Executive Secretariat in association with a Board of Directors. **One of the principal roles for NTI, should it decide to accept this concept development proposal, is to serve as the Executive Secretariat for the Russia Nonproliferation Fund**. A fundamental question regarding a Russia Nonproliferation Fund is whether Russia will be willing to accept the sharing of power that debt swaps necessarily imply. Russia may need to decide if the benefits of a large debt swap outweigh potential sovereignty issues that permit a foreign creditor to share in Fund allocation decisions.

Russia operates on a system of informal personal networks and relationships. The need for personal relationships within the Russian federal government as well as at the regional level is necessary for successful project implementation. Extensive knowledge of the Russian legal system, financial sector, and commercial sector area are just as important to the success of the Fund as knowledge of the weapons complexes. Due to the unstable Russian banking system, Russian banks should be carefully examined prior to their use for funding transactions by the Russia Nonproliferation Fund. In Russia, giving financial assistance to companies without technical assistance, i.e. management procedures, training, creation of associations and support to the nongovernmental sector, lessens the possibility of a successful project. It is important to include a mechanism within these projects that will support the development of project management capability.

The Russia Nonproliferation Fund should be founded as a Russian charitable not-for-profit fund (NFP) according to Russian *Law on NFPs,* No. 7-FZ, 1996. There are two ways to structure the Implementation Team to work under this construct. First, the Implementation Team could be created as a wholly new entity, and the capability would be built from scratch. There are a number of challenges to taking this approach. These can be overcome by utilizing the service of a second approach, that of an existing, reputable Russian entity. Battelle has identified one Russian organization that possesses unique capabilities that correspond to the necessary functions of the Russia Nonproliferation Fund: Delta Capital Management. DCM has the capabilities to address the inadequacy of legal protection, lack of financial reform, lack of project management, and the bureaucratic nature of Russian government regulation.

There are three fundamental roles for NTI if it should decide to lead in the implementation of a Russian debt for nonproliferation initiative: 1) developing creditor contributors, 2) founding the Russia Nonproliferation Fund, and 3) serving as the Executive Secretariat to the Board of Directors of the Fund. ***The fundamental recommendation of this Concept Development Proposal is that NTI should undertake the preparatory work to found the Russia Nonproliferation Fund.***

NTI should immediately direct the considerable influence represented by its Board and by its senior operating officers to the task of garnering authorization and appropriation support for S.1803, Title III, the Debt Reduction for Nonproliferation Act of 2001. The New Partnership between the U.S. and Russia, forged after the September 11th terrorist attacks, provides a motivating backdrop to a debt for nonproliferation swap initiative. The timing is good for NTI overtures to the Department of Treasury to establish a primary point of contact there in order to seriously explore NTI bilateral debt acquisition opportunities with the United States Government.

It is also imperative that a close working relationship with one or more commercial financial institutions be established by NTI in order to stay abreast of market information and receive help identifying creditors. NTI should assemble a prospectus on the charitable contribution tri-partite concept and begin contacting appropriate Russian commercial creditors in the U.S. and abroad on a one-on-one basis to gauge interest.

NTI should also begin interactions with foreign creditor nations to promote the concept, gauge interest, and help establish an internationally recognized role for the Initiative.

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A Nuclear Threat Initiative Concept Development Proposal
Battelle Pacific Northwest Division, Richland, May 2001

Appendix II

Analysis and Strategic Recommendations for Managing and
Financing Major Assistance Projects in the Russian Federation
Institute for Private Sector and Socio-Economic Analysis, Moscow, January 2002

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Analysis of Russian Federation Legislation Regarding Not-for-Profit Entities
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Coudert Brothers, LLC, Moscow, January 2002

I. Preface

As the title suggests, this report documents the studies and analyses conducted on behalf of the Nuclear Threat Initiative (NTI) by Battelle, Pacific Northwest Division staff employed at the Pacific Northwest National Laboratory (PNNL), Richland, WA, on the concept of *debt for nonproliferation*. (Battelle operates PNNL for the U.S. Department of Energy under a contract that permits staff to work for the private sector as well as the public sector.) The Battelle staff who have authored this report are all associated with the Laboratory's Pacific Northwest Center for Global Security, a center that as a hallmark works to consider innovative and non-traditional approaches to enhancing security and the conditions for world peace. The purpose of this work was to determine the viability of and best practices for establishing a ruble *Russia Nonproliferation Fund* to help solve pressing proliferation prevention problems based on one or more debt swap approaches, in which the NTI might assume a leadership role. This work was sponsored as a Concept Development Proposal by NTI under Agreement No. 6004, Battelle No. 43398, during the period July 10, 2001 to January 30, 2002.

The fundamental premise we have been advocating since mid-CY1999 is that, just as debt for nature debt swaps between the wealthier creditor nations and developing debtor nations have been used as innovative financing mechanisms to solve pressing environmental problems, debt swaps should be adapted to proliferation prevention problems. NTI, particularly Ms. Laura Holgate, Vice President for Russia/NIS Programs, is to be commended for her longstanding encouragement of Battelle/PNNL in this endeavor, support that predates her employment at NTI and that was offered while so many others were downplaying the concept. In the end, NTI encouragement has proven to be well-founded. As I write this, the Senate Foreign Relations Committee has recently, by unanimous vote, passed the Debt Reduction for Nonproliferation Act of 2001. This act was co-sponsored by Senators Joseph Biden and Richard Lugar. Senator Jesse Helms, Ranking Member of the Committee, offered during hearings on the Bill that it was an *essential piece of legislation to U.S. national security.* Then, as a final item of business just before breaking for the holiday, the U.S. Senate passed the measure by unanimous consent.

Our conception of the idea developed from a July 1999 seminar given by Dr. John Hardt, Senior Specialist in Post-Soviet Economics at the Library of Congress, to PNNL staff in Richland. From his presentation we learned of Paris Club debt for environment swaps in the early 1990s with the emerging democracies of Hungary and Poland. PNNL was then, and still is, heavily engaged in supporting the U.S. Government, through the Department of Energy, in Russia-focused proliferation prevention. The objectives of these efforts are to minimize the threat of material and expertise leaving the Russian nuclear weapons complex, and to help remove institutional resistance to downsizing it. We concluded that debt swaps, in the context of Paris Club and London Club debt restructuring talks with Russia, might be an innovative and very advantageous way to significantly increase the funding available for Russian nonproliferation programs. Our focus at that time was on the wholesale redirection of Russian weapons production specialists to Cold War ecological legacy problems.

PNNL is located on the outskirts of one the original nuclear cities of the world: Richland, Washington. Our primary defense mission ended many years ago and so we have already had to deal with many of the same problems facing the rest of the closed cities today in post-Cold-War Russia. The local citizenry of Richland were highly motivated starting in 1965 to begin defense conversion. We have had a whole series of robust efforts and formal programs to help us. But it goes without saying that the primary reason for our current economic well-being is the fact that the U.S. Government is funding us at a level of nearly $2bn per year to clean up the nuclear wastes that resulted from weapons plutonium production. I have referred to this situation as the *Richland Model,* and it originally seemed to me that Polish debt for environment programs could be adapted to such cities in Russia as Ozersk, Zheleznogorsk, and Tomsk to solve a whole series of concomitant problems – problems that the post-Soviet Russian economy was incapable to addressing, but that affect people and nations all around the world.

After a number of months discussing the concept with Clinton Administration and then Bush Administration officials; members of Congress, their staff and supporting organizations; and environmental and nonproliferation NGOs, it became quite clear that while the idea of debt-for-ecology was intriguing to our various audiences, the environmental dimension was hindering stronger acceptance of the debt swap concept. We often found that once someone grasped the advantages and potential of debt swaps as they might apply to reducing the threat of proliferation, the dialogue quickly shifted to potential applicability to other security projects. It became very obvious that the better approach to gaining broad support for the concept was to defocus on the projects and concentrate on the debt conversion concept in more general terms, hence the shift from our earlier writings on debt for ecology, to the term *debt for nonproliferation*. (Author's note: As this goes to printing, Finland and Russia have just announced a debt for environment swap as part of a $520mn reduction initiative.)

Early on, we basically undertook a dual-track approach. We focused on official, bilateral debt under the auspices of the so-called Paris Club of industrialized western nations when promoting the concept within the U.S. Government and other G-8 venues; and we focused on private, commercial debt under the auspices of the London Club of commercial financial institutions when trying to gain support from the NGO and private financial communities. As detailed in this report, the two are not quite so separable, and it is not a good strategy to over emphasize this sort of dual-track. Other forms of Russian Federation debt also need to be considered: multilateral debt, regional debt, and contain forms of special debt. Understanding the overlapping considerations between different types of debt and the opportunities for swaps, especially in relation to the potential role of third parties (for example: NTI), was one product of this study. Focusing on debt for nonproliferation debt swaps in more general terms, and broadening our understanding of the overlapping opportunities for innovative financing, considering all types of Russian Federation debt, has been a major factor in garnering recent Administration and Congressional support for debt for nonproliferation. Of course, we hope this report serves the same purpose with NTI because of the significant opportunity and benefit a public-private partnership would bring to the endeavor.

It cannot be left unsaid that there has been another very important factor that has contributed to the recent strong positive support for debt swaps and the associated opportunities to actually make something good, something quite significant happen. The strong support of President Valdimir Putin for the war on terrorism has had a profound effect about how Russia is viewed by the other G-8 members. It would seem that the politics of their relations with Russia, most notably the United States and Germany, have changed by almost 180 degrees. Things that would not be popular with conservative governments politically, like Russian debt conversion, now are. Hopefully this positive political environment will exist for the foreseeable future.

What has been even more volatile over the past two years has been the U.S. and world financial environments. In 1999 when we started promoting this concept, the U.S. economy was robust and healthy. The Russian economy was still on the ropes, though showing some signs of recovery. As the price of oil increased, Russia was able to leave deficit budgeting behind, and debt servicing became possible. The ability to service debt was aided by the significant restructuring agreement between the Russian Federation and London Club creditors in July, 2000. While all this was happening, the U.S. economy was starting the downturn that exists today. Western investors are currently in a state of shock. This downturn has started to spread more globally, to the degree that now Russia actually is viewed as a relatively stable economy with good potential for investment growth. As we have tried to promote debt for nonproliferation through this up-and-down world financial environment, we have tried to remind everyone that the concept is a tool that needs to be considered from all perspectives, not just the U.S. financial community or commercial creditor view. We would argue that the leadership by an institution such as The Nuclear Threat Initiative could bring the kind of focused energy and flexibility to the promotion and implementation of a Russia nonproliferation debt swap process that maximizes the chances for success, effecting a much-needed framework for productive public-private partnerships in this critical endeavor.

Finally, a note about the format of this report. As you can probably imagine, we have obtained volumes and volumes of debt, debt reduction, debt swap, and debt fund information during not only the conduct of this work for NTI, but also as a result of our own related work. One report, at least in my mind, stands out not only for the wealth of information provided, but also the clarity in which it was presented. This report was the work of the Interagency Planning Group on Environmental Funds (IPG).[1.1] We admit to emulating the unique format of that report in our attempt to help you the reader clearly recognize the key points and key issues we want you to understand and remember.

Jim Fuller
December 30, 2001

II. Russian Debt and Debt Swaps

Key Points

There are four basic debt-swap models: buy-back, write-off, rescheduling, and tri-partite arrangements. A NTI debt for nonproliferation initiative would most likely fall under the category of a tri-partite process.

Due to the strong price of oil and gas on the world market in CY2000 and the first half of CY2001, and the London Club debt reduction initiative in August 2000, the financial case for NTI debt for nonproliferation swaps involving either commercial or official Russian debt has significantly diminished – but an extended soft oil market as currently exists could change this situation.

The 2000 London Club restructuring initiative significantly changed the profile of commercial creditors, making it more difficult and proprietary to learn who are the actual bond-holders.

Existing and proposed U.S. legislation allows a direct, official debt swap role for a charitable, private corporation such as NTI.

Because of the current political environment, there may be some interesting opportunities for reducing certain classes of Russian official debt by the United States, Germany, other members of the G-8, and other industrialized nation creditors. There is a role for NTI in developing these opportunities.

NTI needs to lobby the U.S. Congressional process to conference the Biden-Lugar Debt Reduction for Nonproliferation Act of 2001 so that if enacted, work may be implemented with strong NTI involvement by establishing a Russia Nonproliferation Fund.

Key Terms

Debt Restructuring: the process by which a creditor and a debtor agree to change the terms of a loan agreement around principal, interest, and/or time-to-maturity, often resulting in some net forgiveness to the debtor

Debt Forgiveness: a change in the terms of a loan agreement leaving the borrower with a net reduction in liabilities, usually at a net loss to the creditor

Debt Reduction: used synonymously with *debt forgiveness*

Debt Swaps: in the general sense it is the reduction of external debt in exchange for debtor commitment to mobilize domestic resources (local currency or other assets) for an agreed-upon purpose (sometimes used differently in a more restricted sense as shorthand for the tri-partite debt conversion mechanism)

Debt Conversion: used synonymously with the general definition of *debt swap*

London Club: the group of private creditors (banks) that held $32bn worth of Soviet-era debt on which Russia defaulted in the financial crisis of 1998, which was later restructured into Eurobonds

Paris Club: the group of official creditors consisting of the major industrialized countries who act as a group to resolve a debtor country's inability to service their official/bilateral debt

PRINs: (Principal and Interest Notes) Soviet-era commercial notes that were absorbed by the Russian Federation and restructured in 1997

IANs: (Interest in Arrears Notes) commercial interest notes accumulated from original principal debt unpaid by the Soviet Union and absorbed by the Russian Federation

PIDs: (Past Interest Due) interest notes accumulated from interest not paid on the original debt to the commercial sector from the Soviet Union and absorbed by the Russian Federation

Eurobond: a type of long-term IOU issued by a government on foreign currencies as a way to generate funds

Coupons: the interest to be paid on the Eurobond principal, typically on a regular basis such as semi-annually or annually, throughout the life of the loan

COMECON debt: debt owed by Russia to countries of the Council for Mutual Economic Assistance (Bulgaria, Czechoslovakia, Hungary, Poland, Romania, East Germany, Cuba, Mongolia, and Vietnam)

Lend-Lease debt: debt from U.S military assistance to allies just prior to and during WWII

Key Issues

- What is the total Russian external debt and how is it distributed?
- What is the history of U.S. debt forgiveness initiatives?
- What are the most common debt conversion mechanisms?
- What are the most viable debt swap options, particularly from the NTI perspective?

Russian External Debt

A government can acquire three types of long-term debt in international markets to generate budgetary funds. They are bilateral, multilateral, and commercial/private debt. Bilateral debt is the official debt acquired from other governments, and includes both public debt and publicly-guaranteed debt. The most common form of publicly guaranteed debt is export credit, which is usually non-concessional debt (credit extended at market rate interest). (Concessional debt is debt obtained at an interest rate below the current market rate.) Multilateral debt is the debt acquired from multilateral financial lending institutions such as the International Monetary Fund (IMF), the World Bank, the Asian Development Bank, the Inter-American Development Bank, or the European Bank for Reconstruction and Development (EBRD). Commercial/ private debt is the debt acquired from commercial banks, individuals, and investment firms. Almost any debt restructuring initiative between a country such as the Russian Federation and a creditor institution can be fertile ground to effect a debt swap.[2.1]

The Russian Federation, emerging from the breakup of the USSR, began its transition to a market-based economy in 1991 with a substantial amount of external debt that was inherited and/or absorbed from the states comprising the former Soviet Union (*Soviet-era debt)*. Since that time, the Russian Federation has increased its participation in the international financial markets, acquiring additional new debt. The overall picture of Russia's external debt changes continuously as borrowing grows and older debt is serviced, thusly so does the context in which debt reduction for Russia needs to be considered.[2.2]

One cannot clearly understand the current external debt profile of Russia without at least some understanding of the financial crisis of 1998. As economic activity slowed down and Russia continued to borrow in the international market, Russia was not able to service the debt it absorbed from the former USSR. In fact, the crisis of 1998 started with the economic slow down during the mid-80s, and later, extensive capital flight set the stage for contraction and an impossible fiscal situation that led to a crisis.

By the middle of 1998, Russia was dealing with an unprecedented financial crisis. It had a struggling economy with tumbling oil prices and tumbling futures prices in metals. At that time, the Russian Government failed to sell its 75% stake in Rosneft (a state-owned oil company). This failure is credited with triggering a wave of speculation that attacked the ruble, forcing its devaluation.[2.3] During that period, U.S.

banks had a total exposure of $6.74bn held by six major banks and $857mn held by U.S. regional banks. For example, BankAmerica had about $528mn and Chase Manhattan just under $1bn. It was estimated that a debt restructuring of Russian commercial debt having a 35% write-down would cost the six U.S. major banks approximately $1.5bn.[2.4]

In response to the 1998 crisis, Prime Minister Sergei Kiriyenko introduced a plan of austerity that included a reduction in government expenditures of $10bn. In addition, the Central Bank tripled its interest rate and sold millions of dollars to prop up the ruble. However, very few investors saw Kiriyenko's actions as a sign that Russia was moving in the right direction or as an opportunity to buy some valuable assets at low prices. Instead, most observers and investors retreated, seeing Kiriyenko's plans and proposals as not likely to succeed because of rampant corruption, ineffective tax collection, outdated tax codes, lack of corporate governance, and inter-enterprise nonpayment.[2.3]

Inter-enterprise nonpayment, a Soviet problem exacerbated by the 1990s privatization process, arose as companies that bought materials and/or products from others as inputs to their final products, could not afford to pay for the product or service. This further reduced the shortage of revenue because companies did not settle their debts at all, or settled them in-kind. This in turn allowed them to evade federal taxation, thus reducing government revenues even further. This reduced the government's ability to deal with required expenditures, including external debt servicing. By then, Russia's gross domestic product (GDP) had contracted 4.9%, while federal government debt had increased to $152.4bn with $16.6bn in external debt service due.[2.3]

On December 18, 1998, Veneshecombank failed to make an interest payment of $363mn to the London Club of creditors that had been due December 2, 1998. The required payment was for principal and interest notes that amounted to $20bn of a total $26bn owed to the London Club. Veneshecombank was (and still is) the bank responsible for making payments on the London Club debt. Russia was in default of some important commercial loans, which raised serious questions about its overall solvency. The collapse of the ruble made servicing the dollar-denominated debt unsustainable. Full debt servicing would have absorbed over 80% of total projected federal revenue. Therefore, Russia chose to default on most of the Soviet inherited debt, representing two-thirds of its total debt obligations.[2.5]

In August 1999, commercial lenders to Russia met in Frankfurt to explore a long-term resolution of Soviet-era commercial debt. The discussion centered on principal and interest notes (PRINs) and issue interest and arrears notes (IANs). These instruments were the result of a previous restructuring that took place in December 1997.[2.6] In order to undertake this discussion, the London Club had appointed nine delegates representing the hundreds of private creditors to Russia. Their task was daunting because a debt restructuring agreement required approval from 98% of PRINs holders and 95% of IANs holders. For these discussions an Advisory Committee was formed. This committee was chaired by Wolfgang Wendt, then of Deutsche Bank. The members of the Russian London Club Advisory Committee were:

- Banca Nazionale del Lavoro S.p.A

- Bank Austria AG
- Bank of America NA
- Banque National de Paris
- Commerzbank AG
- Credit Lyonnais
- Deutsche Bank AG
- Dresdner Bank AG
- JP Morgan. [2.7]

In September 1999, a Russian Federation delegation headed by the Minister of Finance, Mikhail Kasyanov, met with the Russian London Club Advisory Committee. At this meeting the Russian Federation made a proposal to the London Club committee, based upon their analysis of Russia's mid-term financial prospect, for a comprehensive restructuring of all London Club debt including significant debt reduction. The committee informed the Russian delegation that any debt relief would require that new obligations be in the form of Russian Federation Eurobonds. Russia historically has never defaulted on its Eurobond debts and has paid these obligations before any others. Russia considers Eurobonds as the critical debt instrument representative of its credit worthiness.[2.7]

In February 2000, the Russia Federation and the London Club Advisory Committee met again to finalize the rescheduling of $31.8bn of Soviet-era debt. At that point, the debt was comprised of $22.2bn in PRINs, $6.8bn in IANs, and $2.8bn in past interest dues (PIDs). The Russian Federation offered the following:

- Exchange PRINs for new 30-year Eurobonds at 37.5% discount
- Exchange IANs for new 10-year Eurobonds at 33% discount
- Exchange PIDs for new 10-year Eurobonds at no discount with 9.5% of value due in cash at time of swap.[2.7]

All new instruments to replace PRINs, IANs, and PIDs were issued as Eurobonds in two bundles named *Russian 30s* and *Russian 10s*. They were structured as funds that pay a portion of the principal at specific dates throughout the life of the bond until maturity, with coupon payments on a semi-annual basis. A coupon is the interest to be paid on the principal throughout the life of bond. Russian 30s were issued with a coupon of 5% fixed semiannually while Russian 10s were issued with a coupon of 8¼% fixed semiannually. When combined with an eight-year grace period on payment of principal, plus a lower interest rate, total debt forgiveness, measured in present value terms, amounted to 52%.[2.8] Debt conversion swaps were not a component of the London Club actions, and so an opportunity was missed.

The completion of the London Club 2000 agreement marked the normalization of the relationship between the Russian Federation and its private creditors. However, this restructuring caused a significant and impactful transformation in the private sector debt-holder profile. Before the 1998 crisis, a significant number of creditors were the major banks of the world. This restructuring introduced a larger number and different type of creditor in Russia. Now, investment managers, insurance company investors, and private individuals dominate as holders of this debt. The new Eurobonds that were issued to replace the Soviet-era London Club debt paper are presently spread across many countries and many accounts.[2.7]

The basic profile of the current Soviet-era Eurobond holders is shown in Figure 2.1.

Battelle undertook significant effort to obtain a complete listing of Russia 30s and Russia 10s Eurobond holders. We learned from talking to creditors and investment firms (Deutsche Bank, Brunswick UBS Warburg, The Frank Russell Company, Morgan Stanley-Dean Witter, Scully Capital, Troika Dialog and Emerging Market Trade Association) that it was impossible for anyone to know all the holders of these instruments at any moment in time. This is because Eurobonds are highly traded instruments and what may be true at a certain moment in time will not be true five minutes into the future. It is additionally problematic because a significant portion of the holders are investment managers and insurance companies, in Russia and outside Russia, who are managing investments for clients and cannot reveal this information. Battelle did learn that about 20% of the bonds are held by some of the original holders and that over 40% of the bonds are held by some of the major investment managers across several countries (see Table 2.1). Consequently, Battelle was only able to build a general profile of current Soviet-era Eurobond holders.

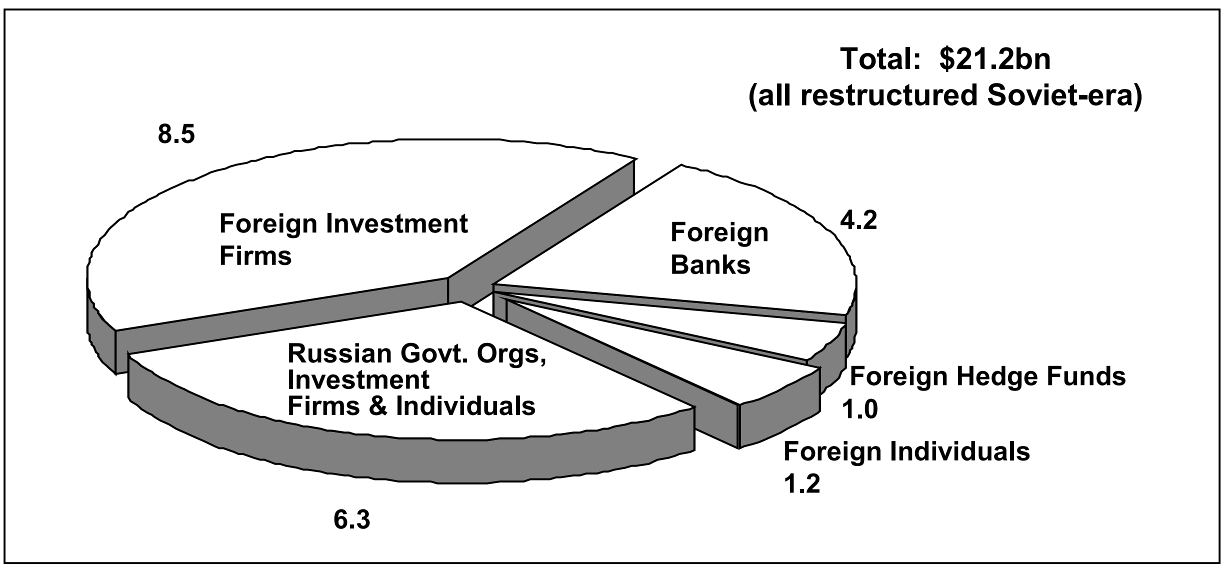

Figure 2.1 Profile of Russian London Club Debt ($billions) [2.9]

Table 2.1. Listing of Russian London Club Debt Holders [2.9]

Russian government related organizations and Russian banks, investment houses, corporate and private individuals—30%.	
Venesheconombank	Alfa Bank
Bank of Moscow	International Moscow Bank
International Bank of Saint Petersburg	Moscow Narodny Bank
Gazprombank	Trust and Investment Bank
GUTA Bank	Lukoil Reserv Investment
Aton Capital Group	Troika Dialog
Original Holders—20%	
Banca Nazionale del Lavoro S.p.A	Bank Austria AG
Bank of America NA	Banque National de Paris
Commerzbank AG	Credit Lyonnais
Deutsche Bank AG	Dresdner Bank AG
JP Morgan	Commerzbank AG
Credit Suisse First Boston	Chase Manhattan Bank International
Non-resident dedicated emerging market investors—40%	
Bloomberg Generic	Fidelity Management - U.S.
Credit Suisse – Italy & Japan	Robeco Investor – Luxemburg
Putnam Investor – U.S.	INA Advisory – Luxemburg
SD Asset Management - Luxemburg	Morgan Asset – U.S.
Capital International Inc – Luxemburg	Westlb Capital – Luxemburg
Mackay Shields – U.S.	Banca Lombarda – Luxemburg
GMO Emerging Country Debt – U.S.A	1784 Ahorro Dolares CI, Argentina
Deutsche Emerging Markets Debt Fund – U.S.A	Fidelity New Markets Income – U.S.A
CB-Rent-Spezial-Adig, offshore	Scudder Emerging Market – U.S.A
UBS (Lux) Emerging Ec-Glbl Bonds – Luxemborg	Franklin Templeton Investment Emkt Bond, Luxemburg
JPM Lux-Emerging Markets Fxd Inc. – Luxemburg	Capitalgest Bond Emerging Market – Luxemburg

Total Russian external debt is estimated to be approximately$147bn, with nearly $71bn being from the Soviet era.[2.10] This total amounts to almost 140% of projected exports and is roughly 42% of projected 2002 gross domestic product (GDP).[2.11] Overall Russian private/commercial debt still amounts to about $65bn, with approximately $21bn of that being Soviet-era as described above.[2.12, 2.9] Russia's bilateral official Paris Club debt currently amounts to about $45bn, with about $36bn being Soviet-era. Approximately $2.7bn of the U.S. portion of official debt is from the Soviet-era, with $480.5mn in the form of Lend-Lease debt dating from WWII.[2.8,2.13] A graphic breakdown of the overall and Paris Club Russian Federation debt is provided in Figures 2.2 and 2.3. Table 2.2 provides additional detail on the overall external debt picture, showing the net effect of debt acquisition and servicing over the past two years for all Russian official bilateral creditors.

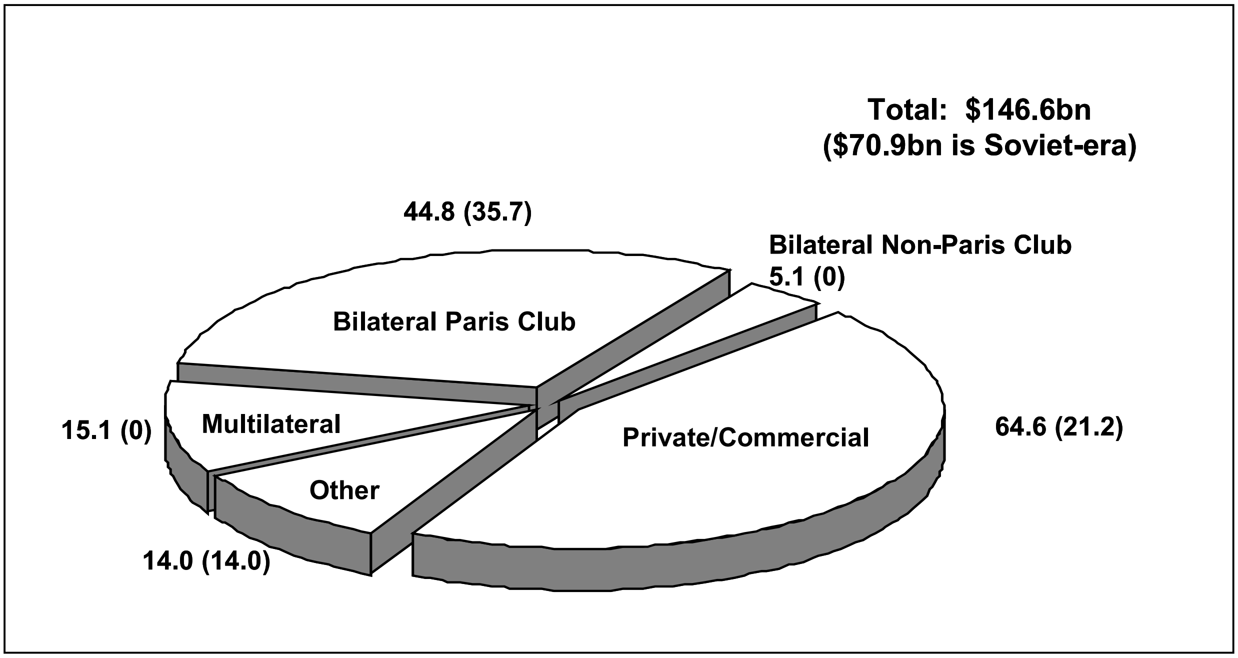

Figure 2.2 Profile of Russia's Total External Debt ($billions) [2.10]

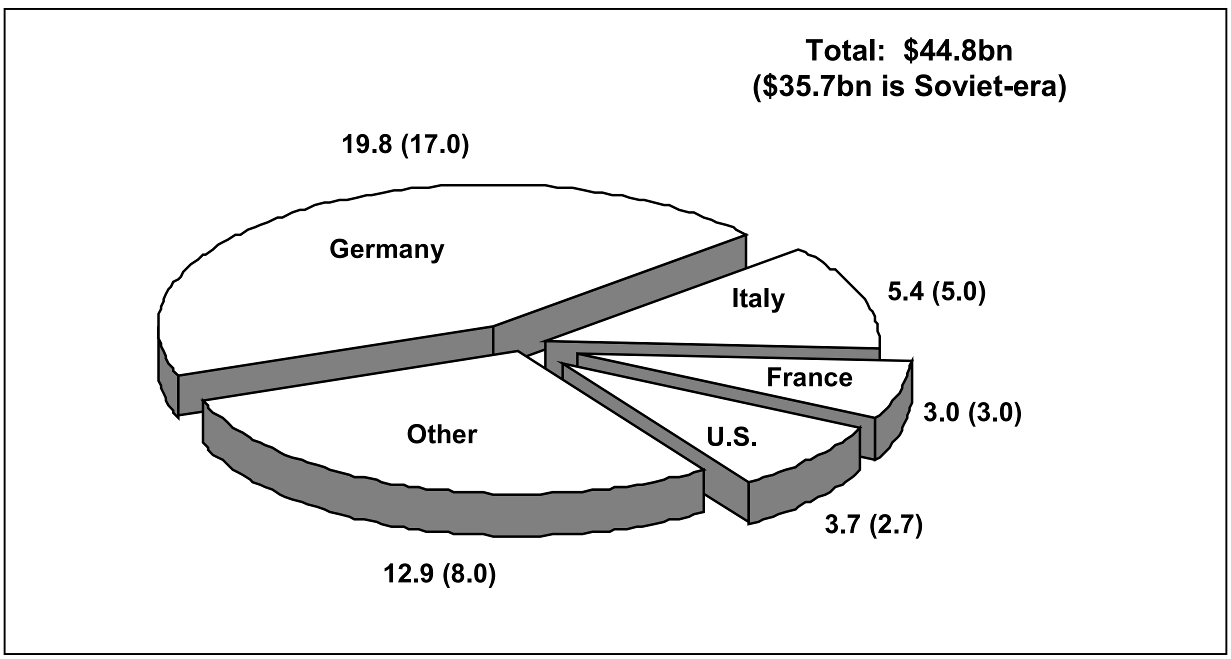

Figure 2.3 Profile of Russia's Paris Club Debt ($billions) [2.10]

Table 2.2 Russian Bilateral Debt ($bn) [2.10]

	Jan. 1, 2002*	Jan. 1, 2003**
TOTAL	**63.9**	**59.8**
Australia	0.4	0.4
Austria	2.4	2.4
Belgium	0.6	0.6
UK	1.5	1.4
Germany	19.8	18.0
Denmark	0.2	0.2
Spain	1.0	0.9
Italy	5.4	5.2
Canada	1.7	1.7
Netherlands	0.5	0.6
Norway	0.0	0.0
Portugal	0.1	0.1
U.S.A.	3.7	3.5
Finland	0.5	0.5
France	3.0	2.8
Switzerland	0.3	0.3
Sweden	0.1	0.1
Japan	3.5	3.5
Greece	0.0	0.0
Egypt	0.3	0.3
Kuwait	1.7	1.6
Malta	0.0	0.0
UAE	0.9	0.9
Oman	0.1	0.0
Thailand	0.0	0.0
Turkey	0.4	0.4
Uruguay	0.0	0.0
South Korea	1.7	1.6
COMECON countries	14.0	12.8

*estimates ; **projected

In addition to the London Club, The International Monetary Fund (IMF) and Paris Club have also provided some debt relief to Russia. In July 1999, a Russian/IMF agreement was signed providing for $4.5bn to be used primarily to service the debt from that multilateral organization. Multilateral international financial institutions such as the IMF and World Bank do not generally engage in swaps as a component of restructuring, however. In August 1999, the Paris Club provided a framework agreement that postponed payment of debt principal until after the presidential election, i.e., 2001, but continued interest obligations.[2.8]

During the 1990s the U.S. government undertook a considerable amount of official debt reduction activities within the framework of the Paris Club. Throughout this period the U.S. reduced the debt owed by 39 countries. The U.S. government has participated in programs like the Toronto Terms, where debt flows of non-concessional loans were reduced by 33% and rescheduled; under London Terms, where the U.S. rescheduled debt while forgiving 50% of eligible non-concessional debt; under Heavily Indebted Poor Countries (HIPC) Terms where up to 80% of debt stock and flow were reduced on eligible non-concessional debt combined with proportional debt reduction from international financial institutions (IFIs); Enhanced HIPC Terms, where up to 90% of debt stocks and flows were reduced on eligible non-concessional loans and up to 100% of concessional debt combined with proportional debt reduction from IFIs.[2.14] Unilaterally, the U.S. has undertaken debt reduction through swaps and buybacks for USAID and USDA concessional debt. For example, under the Enterprise for the Americas Initiative (EAI) the U.S. reduced concessional debt owed by eligible countries in Latin America and the Caribbean for conservation and child survival programs; and under the Support for East European Democracy (SEED) Act the U.S reduced debt as a reward for taking steps towards democracy and market economies. The U.S. also enacted special legislation for Poland, Egypt, and Jordan to reduce their debt, assisting their economic reform and furthering U.S. national security interests.

Germany, with 48% of the estimated $42bn Russian Paris Club Soviet-era debt, will chair any upcoming Paris Club meeting and have substantial influence on the outcome. The U.S. share is about 6% of the total Paris Club debt. Italy, France, and the United Kingdom appear to take their guidance for debt negotiations from overall policy established by the IMF and major creditor nations.[2.8] The conditions brought on by the collapse of the ruble have, until recently, been somewhat offset by the strong price of oil. The situation in 2002 is less optimistic due to the significant oil price downturn, though the Russian Federation is maintaining a strong posture saying that Russia will meet its $14bn debt service obligations this year, a figure that amounts to about 38% of its foreign reserves.[2.11,2.15] A weak posture by Russia would exacerbate any downturn in Russia's economy by reducing investor confidence. It remains to be seen if Russia can maintain its current rate of positive economic growth and relative vitality, or whether some future action by the Paris Club will be warranted. In 2003, substantially greater Paris Club debt servicing will be required, and with a prolonged soft oil market, Russia could find itself in trouble economically.

It is easy to understate the problem of Russian sustainability of debt obligations. Russia has had both cash flow (liquidity) and budgetary (solvency) problems in the servicing of its external debt. Currently, the latter is the more serious problem. High oil prices resolved the liquidity problem with the buildup of dollar reserves in the Central Bank. Falling oil prices will especially affect the budgetary problem because the

Ministry of Finance will need to buy dollars with rubles from the Central Bank to service the debt. The ruble appropriations required for servicing the debt will likely squeeze budgets for reform: revenues from oil and gas sales account for about one-half of the federal budget and gas and oil prices tend to go together.[2.8]

In deciding whether to grant debt forgiveness and under what terms, the Paris Club would take several factors into consideration. Along with the cost of debt forgiveness to creditor nations, the Paris Club would consider the importance of precedents from previous debt agreements, the Russian Federation's long-term economic sustainability, and the appropriateness of non-economic considerations such as the implications of debt forgiveness on foreign and security policy. The initial German position on debt forgiveness, formally announced by the German Paris Club representative after the 2000 London Club agreement, was no previous debt settlement, especially the London Club agreement, established a precedent for Paris Club negotiations. As stated publicly, it is the German view that the Russian Federation should be able to service its debt with improved economic performance, a better use of natural resources, and a return of flight capital. The German position does not acknowledge the benefits of a more liberal debt relief agreement that might accrue to arms agreements, foreign policy cooperation, and other non-economic issues. While Germany's official position may change, this conservative view seems to be widely held and is quite logical given the impact of Russian Paris Club loan default on the FRG federal budget.

Despite the present economic situation, some skepticism remains about Russia's ability to service its foreign official debt, perhaps because Russia's sustained economic health is primarily based on a single commodity (there is increasing concern about Russia's ability to service its future debt in full if oil prices fall below $15/barrel) and an expectation of a significant increase in commercial investment in Russia. Russia still suffers from capital flight at the same time the Central Bank is pulling money out of circulation to build up reserves and keep inflation under control. This creates a reduction in funds available for borrowing by individuals and companies, triggering a slowdown in demand and in overall economic activity. The Russian Central Bank has increased its international reserves to $36.5bn (as of January 18, 2002). Since September 2001, oil prices have declined 40%, creating concerns about Russia's future ability to repay both its debt and meet other budgetary obligations.

London Club creditors believe that the most viable debt for restructuring in the event Russia has financial difficulties is Paris Club debt. The loss taken by the London Club during the 2000 restructuring was significant, and Russia has been servicing all its Eurobond debt. The incentive for any London Club institutional forgiveness is very low at this time.[2.16]

Early in CY2001, President Vladimir Putin made the Paris Club debt negotiations a centerpiece of the Russian Federation's economic relations with the West, and the United States in particular. Putin and Prime Minister Kasyanov announced in February 2001 that London Club relief was welcome and necessary but insufficient, and that they expected the Paris Club to match the same 50% degree of forgiveness. The Russian Government failed to include debt payments in its FY01 budget in order to induce Western creditors to restructure foreign debt. But later in the year when the Paris Club, Western creditors and the IMF made it clear that payment was expected, President

Putin and Prime Minister Kasyanov acknowledged full responsibility for the debt and agreed to timely payment. This was recently reaffirmed as noted above.

In exceptional cases, governments may pass special legislation to permit debt reduction or debt swap aimed at specific nations. For example, the United States has reduced bilateral debt to promote not only economic reform but also U.S. national security interests. In 1991 the United States reduced Poland's debt by $2.5bn in recognition of its strategic importance in stabilizing Eastern Europe and transforming Eastern European countries into market-oriented democracies and in recognition of the role Polish armed forces played in the Allied victory in World War II. Also in 1991, Congress supported the forgiveness of $7bn for Egypt, its total military debt to the United States, in recognition of its key role in solidifying the Persian Gulf War coalition. Finally, in 1994, Congress enacted special legislation that forgave Jordan's $700mn debt to the United States in recognition of the positive role it plays in stabilizing the Middle East.[2.14] The Polish-Paris Club agreement will be discussed in more detail in Chapter III because in addition to the 50% debt forgiveness package, the United States and four other governments agreed to swap a portion of Poland's bilateral debt in return for Poland's commitment to fund environmental remediation programs.

There is one special case of debt that needs to be reviewed that falls outside Paris Club or London Club considerations: GDR debt. Russian GDR debt is money now owed by the Russian Federation to the unified Federal Republic of Germany that was once owed by the Soviet Union to East Germany, the former German Democratic Republic. The exact amount of this debt is the subject of focused negotiation between the two countries. What is interesting about this debt is that it is not included in the German federal budget, and it is highly improbable that this debt will be serviced through actual cash payments by Russia to the FRG. The Germans have set the level of this debt at about $6.4bn, the Russians much lower. Informal settlement proposals have included debt for equity (Germany) and debt for investment (Russia), with neither proposal evidently striking the fancy of both parties. Debt for nonproliferation should be considered in this context, providing the FRG with an attractive complement to any U.S. or other G-8 proposal having the same basic objective.

Debt Conversion Mechanisms

The mechanisms that may be used to effect debt swaps can be grouped into four basic categories.[2.17]

1. **Buy-Back.** A debtor nation, after a negotiation, purchases debt directly from a creditor at less than face value, and at the same time underwrites a fund in local currency to conduct work in the debtor country that is of value to both the creditor and the debtor.

    - In 1998, Peru repurchased $177mn of USAID concessional debt for $57mn and entered into an Environmental Framework Agreement that required Peru to contribute in local currency the equivalent of 40% of the buyback into a fund to support environment and child survival programs.[2.14]

2. **Write-Off.** A creditor agrees to just forgive some portion or all of an outstanding debt in exchange for the establishment by the debtor of the swap fund as described above.

   - In 1992, J.P. Morgan donated $11.5mn in Bolivian bank debt to fund conservation and environmental programs. The donation, organized by The Nature Conservancy and the World Wildlife Fund, represented the entire amount of J.P. Morgan's Bolivian debt.[2.18]

3. **Rescheduling.** Creditors agree to reschedule the servicing of old debt by exchanging a large amount of paper for a smaller amount. In the case of official bilateral debt rescheduling, some portion, such as the interest payments, are re-directed into a swap fund. In the case of commercial debt, principal and interest are often separated into derivatives, which can also be used separately.

   - The U.S. and the government of El Salvador entered into a rescheduling agreement in June of 2001. About $38mn in debt was rescheduled down by about $3mn establishing a new loan in the range of $35mn to be repaid over 26 years. Interest payments totaling about $14mn over this timeframe are being redirected to creating a new environmental conservation fund. The deal cost the U.S. government about $7.7mn in appropriated funds.[2.19]

4. **Tri-Partite Arrangements.** A third party such as an international non-governmental organization receives a donation and/or purchases paper from a creditor and negotiates a write-off with the debtor nation.

   - In 1987, the World Wildlife Fund purchased $1mn in Ecuadorian debt and assigned the debt to an Ecuadorian environmental NGO. The Ecuadorian government issued bonds, which paid interest in local currency into an environmental fund. Proceeds of the fund were distributed to the local NGO which used the money to finance protection of nature reserves.[2.20,2.21]

As suggested from the examples for each mechanism above, there are some very important lessons to be gained from the environmental movement in the leveraging of debt reduction activities to effect global ecological objectives. Debt for nature swaps were conceived in 1984 by the World Wildlife Fund.[2.22] Dept swaps have since been applied to a variety of fields, including debt-for-health, debt for charity, debt for child development, and debt-for-sustainable development.[2.23] In these exchanges, a portion of a country's restructured debt is forgiven in return for local currency, which is applied to an environmental project. These debt swaps have involved both official bilateral debt and commercial debt. Commercial debt becomes available for debt swap when banks sell at a discount debt instruments of low market value. Banks may also donate debt, typically, in order to generate good will and to take advantage of federal tax codes that allow the banks to write-off debt when donated to a charitable not-for-profit corporation.[2.24,2.18] Debt for nature swaps amounting to nearly $1bn have been implemented over the last two decades.[2.25]

Prior to 1990, most debt for nature swaps involved relatively small amounts of debt and were primarily organized by international NGOs.[2.26,2.27] In the 1990s, a second generation of debt for nature swaps evolved relying much more on governments to play a lead role in sponsoring exchanges.[2.28,2.29] They involved much larger amounts of debt, thus offering greater leverage in effecting change. Because government was a central player, greater emphasis was given to enforcement of contractual arrangements by the creditors. These transactions have shown the importance of strong NGO and debtor government involvement in creating and monitoring transactions. They also highlight the need for oversight and enforcement of agreements by creditor governments to make debt swaps acceptable to the taxpayers and governments of creditor nations.[2.30]

Debt Swap Options

With regard to commercial debt, the viability of any debt swap initiative is first and foremost dependent on financial considerations of debt reduction. Several factors come into play amongst creditors who hold debt paper. These include the borrower's overall recent economic performance (the borrower's ability to pay its debt), as well as the borrower's ability to fulfill its internal budgetary obligations and stimulate economic activity in the future. Also included is creditor confidence in getting an acceptable return on the investment. The confidence of a country's ability and willingness to meet its debt obligations is most often gauged through credit ratings. There are several major credit rating entities (S&P, Moody's, FITCH) used by investors and creditors in evaluating credit worthiness. These entities track, rank, and rate every nation's economic and political health and establish parameters that indicate a country's credit worthiness.

As of today, private creditors and bond holders seem to generally expect Russia to make its payments on all its debts including the relatively large total service of $18.3bn due in 2003. They generally believe, based on recent performance, that Russia can still service its debt and retain a solvent federal budget even if oil prices fall to $15/barrel. This in turn provides Russia with improved credit ratings, and thus the ability to go back into the market and borrow additional funds.[2.16]

Russian Soviet-era Eurobonds have experienced improvement in trading value throughout 2001. Present holders of these bonds consider them to be a good investment and, at the moment, they are not likely to be traded below market value or donated to an institution strictly for financial reasons. On November 27, 2001 the Fitch agency upgraded all Russian long-term credit ratings including Eurobonds from B to B+.[2.31] That same day the *Moscow Times* reported that the upgrade was in response to an announcement made by the Venesheconombank to pay down a $1bn Eurobond without having to come back into the market for refinancing.[2.32]

The Deutsche Bank, which was one of the original London Club creditors and which still holds converted Eurobonds, considers the converted bonds as good as any of the newer Eurobonds that Russia has issued since the restructuring. New era Russian Eurobonds have been trading at 102% and 104% of their face value. Troika Dialog, a Russian investment company that holds some of the converted bonds, stated that there is no financial gain in selling such holdings at less than trading value or in donating them to an institution.

As of December 5th, 2001, Russian 30s and 10s, while improving in trading value in the last six months, were trading at 55.1 cents on the dollar (c/d) and 86.5 c/d.

Because of the recent Eurobond repayment they have continued to increase in trading value. On January 11th 2002, the Russian 30s and 10s traded at 61.63 c/d and 90.63 c/d respectively. The Russia 10s are trading at closer to face value than the Russia 30s because their maturity date is earlier. While they are not trading at face value they are still considered a good investment since the coupon payments are being made, the scheduled principal payments are also being made, and it is expected that upon maturity the holder will get 100% of face value. Because the estimated price of money is about 7% (what the U.S. dollar is estimated to appreciate from now until maturity of the bonds), the yield of these bonds is presently estimated to be 11% to 15%, factoring in the coupon payments. When compared to the U.S. Treasury bonds that are offering 5%, the Russian Eurobonds appear to be an excellent investment. This will be the case as long as Russia continues to make its commercial debt payments.[2.9]

With regards to official debt, U.S. Government policymakers to whom we have spoken also generally discount the notion that there is compelling financial incentive to consider Russia bilateral debt restructuring and thus swaps, within the context of the Paris Club. This basically supports the German view. While the Bush Administration and the Paris Club must be aware of the potential impacts of a soft oil market, evidently the duration and/or severity of this situation is not great enough to warrant significant concern at this time.

Recently, however, there has been considerable political interest expressed within the U.S. Congress toward debt for nonproliferation. On December 20, 2001, the Senate passed by unanimous consent the Security Assistance Act (S. 1803) containing the Debt Reduction for Nonproliferation Act of 2001 (DRNA). The DRNA was sponsored by Senators Joseph Biden and Richard Lugar and co-sponsored by Senator Jesse Helms. It sets forth U.S. security interests in preventing proliferation and reducing weapon stockpiles, especially in Russia. It recognizes that existing nonproliferation programs have made substantial progress but that the threat remains urgent, that new nonproliferation funding streams such as debt reductions and exchanges are needed, and that the burden will have to be shared by Russia, the United States, and other debt-holding governments. It further states that Russia's substantial Soviet-era debt burden severely stresses its budget, will do so even more in 2003 and thereafter, and is among the factors that has led Russian officials to recognize that its future lies with the West. The Act is likely to be taken up soon after the Congress returns early in 2002 in a Senate-House conference led by the two foreign affairs authorizing committees.

If enacted in its current form, the DRNA would authorize the President to establish “The Russian Nonproliferation Investment Facility” at the Department of Treasury to administer the debt reduction. It would authorize the President to reduce the amount of Soviet-era Lend Lease and agricultural debt and replace those obligations with new obligations defined in a “Russian Non-Proliferation Investment Agreement” that would be negotiated with the Russians and result in a ruble-based Russia Nonproliferation Fund. In compliance with the Credit Reform Act of 1990, the DRNA would authorize an appropriation to the President in FY02 of $100mn to offset the cost to the U.S. Treasury of the debt reduction ($50mn for Lend Lease debt reduction and $50mn for agricultural debt reduction). In FY03 it would authorize an appropriation to the President of $200mn for the same purpose and split evenly between Lend Lease and agricultural debt. The President could sell the debt to an eligible third-party or the Russian Government, provided the required nonproliferation plans, commitments and transparency measures were in place.

The DRNA would require that consequent nonproliferation programs and projects be approved by the U.S. Government directly or via its representation on any governing board established to manage the funds, incorporate best practices from established threat reduction and nonproliferation assistance programs, be subject to U.S. audits, remain free of Russian taxes, and that 75% of such funds be spent in Russia. Senator Helms suggested two additional provisions that, like all other measures of the DRNA, would be implemented at the discretion of the President. One would authorize the use of up to 10% of such funds to promote an independent media sector and the rule of law in Russia. The other would require Presidential certification that Russia was making material progress in stemming the flow of sensitive goods and technologies to states designated by the Secretary of State as supporting terrorism (but would provide a Presidential waiver of this required certification if the President determines it to be counter to U.S. national interests). Finally, the DRNA would instruct the President (or his designees) to seek the appropriate agreements and arrangements in the Paris Club and establish an interagency committee to ensure that U.S. public and private efforts are not in conflict, and that public and private spending on these purposes is maximized, is efficient, and furthers U.S. national security interests.

The DRNA legislation starts a special legislative debt forgiveness process that is motivated more by the political situation than by the financial health of Russia. This is very similar to previous U.S. initiatives for the nations of Poland, Egypt and Jordan. The *New Partnership* between the United States and the Russian Federation is a result of the Putin Administration's support for the war against terrorism. The situation is also strengthened by actions, such as Russia's resistance to OPEC pressures to drastically reduce oil production.

NTI is in a position to play a critical role by promoting and publicly supporting the DRNA. It is crucial that NTI not only offer the full weight of its influence in this regard, but also promote the vehicle of a Russia Nonproliferation Fund as analyzed and described in great detail in the balance of this report.

NTI can participate in bilateral debt reduction swaps through the tripartite debt process described earlier under provisions of both the DRNA and the Credit Reform Act of 1990. These authorize the President of the United States to sell to eligible private purchasers any loan or any credit held by the U.S. government or any portion of a loan or credit that qualifies under DRNA for the purpose of facilitating a debt for nonproliferation exchange to support activities that further United States objectives. It is quite conceivable to the authors that NTI, for political and security reasons, could influence the U.S. Government to devalue portions of its older (Soviet-era) Russia bilateral debt so that it might be acquired by NTI at extremely reasonable prices. NTI could then use this paper in a process of negotiation with the Russian federal government to underwrite the Fund.

Opportunities may still exist for NTI to promote and initiate a debt-swap for nonproliferation with selected commercial/private creditors. In the case of commercial debt there are two potential models for NTI's participation: charitable contributions and debt purchases. Under the charitable contribution model, NTI should approach individual holders of Russian 30s, like Citibank, JP Morgan, or BankAmerica, with the debt for nonproliferation concept as a potential charitable donation (write-off) with the greater goal of security and peace and of facilitating Russia's initial investment into nonproliferation and its cold war legacy. While Soviet-era Eurobonds are currently considered a good investment, their value to the holder/creditor is also influenced by the value of the rest of the holder's portfolio across all their other market investments. For this reason, it is important to approach commercial/private creditors on a one-to-one basis. NTI can also participate by buying some Eurobonds in the market. Under the debt purchase model NTI can purchase a portion of the Russian 30s in the market and exercise a write-off, negotiate a buy-back or a tri-partite arrangement with the Russian Ministry of Finance that will include investing all or a portion of the reduced debt into the Russia Nonproliferation Fund to be established by NTI. The market conditions are not favorable for any discounts as an element of this process, but it would be a very direct and expeditious way of using modest resources to at least establish an NTI-led Fund.

The authors believe that there are four regions in Russia that have also issued Eurobonds. They are Yamalo-Nenetskii Okrug (near Murmansk), Leningradskoye oblast, Sverdlovskoye oblast (where Snezhinsk and Ozersk are located), and Nizhegorodskoye oblast (where Sarov is located). Time and resources were not available as part of the Battelle effort for NTI to really even begin to explore the possibilities of debt for nonproliferation swaps on an individual basis with Russian regional governments. However, it is certainly the case that the horrific Cold War environmental legacy and the exasperating social-economic issues are heavy burdens on regional governments. There should be a real motivation for the regional governors to explore innovative solutions. NTI might find that certain regional debt paper is devalued, thus making it a good candidate for debt swap.

In the case of the German GDR Debt, in a situation that could greatly expand G-8 and other industrialized country participation in debt for nonproliferation swaps, NTI can perhaps play a very effective catalytic role.[2.33] NTI, in coordination with the U.S. Government *or on its own,* could approach the FRG with the debt for nonproliferation concept to help achieve a settlement of the pending debt that would help underwrite the Russia Nonproliferation Fund. NTI could add its influence to help expedite a Russian-German settlement on the value of the GDR debt, concomitantly proposing in this interaction that all or a significant portion of the debt could be dedicated to the Russia Nonproliferation Fund.

The bottom-line of the authors' analysis of the Russian Federation external debt situation is that, while opportunities for leveraged acquisition of London Club debt appear to be low, individual creditors need to be approached on a private basis before abandoning this idea. If the oil market remains soft over the next 12-18 months, the situation will change. This condition would probably impact Paris Club debt more quickly and more dramatically. The authors have learned that the U.S. Government has just begun coordinating at the Principals level on Russia debt for nonproliferation. These discussions are really being driven not by financial considerations, but by political and security reasons, in a process probably hastened by the Debt Reduction for Nonproliferation Act of 2001. NTI can provide leadership in assuring that there is a role for the private sector. This role if established around a Russia Nonproliferation Fund, could lead to increased and sustained partnership in proliferation prevention involving both an expanded international public sector and private sector, and perhaps resulting in an effort characterized by greater effectiveness and speed than the United States Government has been able to effect alone to date.

III. Fund Strategy and Governance

Key Points

A debt swap *fund* (or synonymously, *foundation*) would be the recognized Russian institutional mechanism for managing and distributing the proceeds of a debt swap to projects. Therefore, it is recommended that the charitable not-for-profit Russian entity, the Russia Nonproliferation Fund, be established.

A potential problem in establishing a Russian fund is that funds have been abused in Russia in tax evasion schemes. However, Russian laws provide for the founding of trustworthy and accountable charitable funds.

In debt swaps, two types of bilateral agreements are signed by the creditor and the debtor nation. One defines the financial terms and type of fund to be created, and the other defines the structure of the fund as well as how the proceeds are to be distributed.

Debt swap funds typically incorporate one-tiered or two-tiered management structures. It is recommended that a modified two-tiered structure with a Board of Directors and an Implementation Team be used for the Russia Nonproliferation Fund.

To be successful and to serve multiple obligations and purposes, the Russia Nonproliferation Fund must be based on a partnership where decision making is authentically shared, where there is efficiency and effectiveness in management and operations, and where there is full accountability in Fund allocations and project performance.

A process of Fund asset protection that incorporates the elements of debt agreements, framework agreements, program assurance, and project assurance is considered essential.

A fundamental question regarding a Russia Nonproliferation Fund is whether Russia will be willing to accept the sharing of power that debt swaps necessarily imply. Russia will need to decide if the benefits of debt swap outweigh potential sovereignty issues that permit a foreign creditor to share in Fund allocation decisions.

Key Terms

Endowment fund: a fund that allows only the income from investments to be used to finance a fund's activities; the principal remains intact

Sinking fund: a fund that allows both principal and investment income to be used to finance a fund's activities; when the money is gone the fund expires

Revolving fund: a fund where principal accumulates on a regular basis through receipt of new revenues, and both principal and interest are used

Key Issues

- What is the purpose and important reasons for establishing a Russia Nonproliferation Fund?
- What are the basic types of debt swap funds?
- What lessons can be learned from other cooperative programs that would maximize the conditions for success for a Russia Nonproliferation Fund derived from debt swaps?
- What is a viable model framework for a Russia Nonproliferation Fund in which NTI could undertake an important leadership role?

Purpose and Importance of a Russia Nonproliferation Fund

The ultimate purpose of a Russian debt for nonproliferation fund is to use the resources made available through debt swaps to underwrite proliferation prevention projects in that country. In this context the threat will be reduced by:

- Securing and disposing of WMD materials
- Creating the scientific and economic conditions in Russia so that its weapons specialists remain there, and remain loyal
- Removing hurdles to downsizing the Russian nuclear, biological, and chemical weapons complexes
- Creating an entity (the Russia Nonproliferation Fund) capable of acquiring, using, and accounting for the proceeds from debt for nonproliferation swap agreements.

These goals will be accomplished by pursuing projects that are cost effective, by leveraging existing resources, by financing projects that would not otherwise be undertaken by the Russian government, and by:

- Enhancing sustainable proliferation prevention capacity building in Russia and self investment

- Significantly increasing G-8 and private third party investment and involvement

- Providing a way in times of fiscal constraint for bilateral and commercial creditors to potentially increase return on investments

- Keeping hard currency in Russia while federation debt is reduced, thereby improving the overall economic stability of the country during its transition to a market economy.

Basic Types of Debt Swap Funds

The salient design characteristic of debt swap funds is the way they are established to distribute proceeds of a debt swap. Funds are typically established around one of three constructs, or utilize some combination of the three:

- **Endowments.** An endowment allows only the income from investments to be used to finance a fund's activities. The principal remains intact.

- **Sinking funds.** Sinking funds allow both principal and investment income to be used to finance a fund's activities. Typically the entire principal is invested over a fixed period of time. When the money is gone, the fund expires.

- **Revolving funds.** Revolving funds accumulate principal on a regular basis through receipt of new revenues, such as income from fees or special taxes. Both principal and income are used to fund projects over a more indefinite period of time.[3.1]

The choice of the construct depends on the goals of the fund. Endowments are useful when goals are long-term and directed at capacity building, and costs are relatively modest. Sinking funds are useful when projects have a definite end date or finite objective, such as property acquisition or capital construction. When revolving funds are structured around loans or receive incremental deposits they too can become a long-term financing mechanism, supporting indigenous capacity building, as well as underwriting more substantial efforts.

There are no specific impediments to establishing a debt for nonproliferation fund under current Russian legal structures. The most suitable form of legal entity for a Russia Nonproliferation Fund is technically defined as a *fund* (also translated as *foundation*), under laws governing the creation of charitable not-for-profit organizations.[3.2] This will be discussed in greater detail in the next section.

Given that high rates of inflation are likely to persist in the Russian Federation for some time, it will be important to establish a mechanism to protect the Russia Nonproliferation Fund from these effects in order to preserve the purchasing power of the monies dedicated to nonproliferation projects. There are two generally recognized approaches to preserving fund value. From the U.S.– Russian perspective, these are:

- Ruble payments in constant U.S. dollars. One way to avoid inflationary effects is to structure the debt-swap agreement so that the Fund is not tied to a ruble-denominated account. Rather than demanding a single lump-sum payment into such an account, the agreement would call on the Russian Federation to make a series of annual Russia Nonproliferation Fund payments. And although these payments would be made in rubles, the value of the required deposits would be fixed in terms of constant U.S. dollars.

- Ruble payments from a dollar-denominated account. Alternatively, the total amount of money reserved for the Russia Nonproliferation Fund could be deposited into a dollar-denominated account when the debt-swap agreement is officially consummated. Funds would then be drawn out of this account each year and converted to rubles at the prevailing exchange rate. Because the exchange rate would adjust to correct for the impacts of inflation, the net result would be to preserve the buying power of the fund.[3.3]

One hurdle that needs to be overcome is the fact that funds in Russia have a bad reputation because they have been abused in tax evasion schemes. Nevertheless, Russian law provides for the establishment of viable, trustworthy funds. As will be discussed further, the bad reputation of funds may be overcome by utilizing a multi-national governing board and relying on best-practices learned through the conduct of other successful nonproliferation programs in Russia, and swap initiatives established for other purposes between creditors and other nations besides Russia.

Lessons-Learned from Other Cooperative Programs

The following assessment is based on an analysis of various debt swap, international aid, and cooperative threat reduction programs to see how asset protection is handled in programs of similar purpose. Since there has never been a debt swap devoted to WMD threat reduction per se, there is no specific model available to serve as a guide for creating a debt swap program around nonproliferation. In the following analysis a decision was made to give the most weight to programs with the closest fit to the purpose at hand. Programs that emphasize debt-swap over lending and international aid, and cooperative threat reduction over environmental preservation, receive the most weight in evaluating the contribution of various assurance mechanisms to constructing a debt swap fund. On the basis of this metric, four programs are featured most prominently. The Polish Ecofund and USAID are a focus because of their strong ties to the concept to debt swaps; INSP and CTR are included because their substantive focus is cooperative threat reduction. Other programs examined for this study include: World Wildlife Fund (D.C. and Moscow offices), Nature Conservancy, Eurasia Foundation, World Bank, European Bank of Reconstruction and Development (EBRD), and the Foundation for Russian American Economic Cooperation (FRAEC). These organizations may offer insights into the features of a system of assurance, but due to their missions, are less central to the specific purpose of debt swap around nonproliferation.

The four organizations at the core of the analysis are:

- The **Polish Ecofund** was created in 1992 as the institutional mechanism for managing and distributing proceeds of the Polish-Paris Club environmental debt swap. The Ecofund has been described by the OECD as a *center of excellence* and a model for other financial institutions to follow. The Ecofund provides financial support in the form of nonrefundable grants or, to a much lesser degree, preferential loans. The total amount accruing to Ecofund through 2010, the date when most projects expire, is $473.9mn, of which the U.S. portion is $370mn.[3.4]

- The **U.S. Agency for International Development (USAID)** is a well established international aid organization that works to advance U.S. policy objectives by supporting economic growth, agricultural development, global health, conflict prevention and developmental relief. USAID is the lead agency for intergovernmental assistance and overseeing the creation of debt swap foundations in developing countries. For example, USAID, Department of State, and Department of Treasury serve as the leadership triumvirate representing the seven U.S. agencies on the 15 member President's Board of the Enterprise for Americas Initiative and Tropical Rainforest Act.[3.5]

- The **International Nuclear Safety Program (INSP)** is a cooperative nuclear threat reduction program led by PNNL for the National Nuclear Security Administration. Congressional funding since 1992 has had a direct impact on improving safe operations or assisting in the planned shutdown of 67 Soviet-designed nuclear power plants in Armenia, Bulgaria, Hungary, Kazakhstan, Lithuania, Russia, Slovakia and Ukraine. Independent international safety reviews have identified significant progress in the safe operations of these reactors. Nearly a half-billion dollars has been spent on this program since its inception.[3.6]

- The **Cooperative Threat Reduction (CTR)** initiative began with the Soviet Nuclear Threat Reduction Act of 1991, to address critical proliferation prevention needs in the Former Soviet Union (FSU). This act and subsequent versions authorized material assistance to the FSU to facilitate the safe and secure transportation, storage, safeguarding, and destruction of nuclear and other weapons. Through the CTR program, the Department of Defense provides equipment, services, and technical advice to assist states in eliminating (or in the case of Russia, reducing) the weapons of mass destruction remaining from the Soviet era, preventing proliferation, and dismantling the associated infrastructure. The majority of projects are funded on a contractual basis. Typically, equipment is purchased in the U.S. or internationally and shipped to FSU countries. As a front-line WMD threat reduction program, the problems and challenges it has faced will provide particularly useful lessons for debt for nonproliferation.[3.7]

The survey of organizations conducted for this analysis shows that goals of transparency, accountability and objectivity are served by an asset protection system, a feature of all successful bilateral programs, comprised of interconnected and overlapping assurance processes and mechanisms. Such a system can be described as consisting of four basic structural components: debt agreement, framework agreement, program assurance, and project assurance.

Asset protection speaks directly to the needs and concerns of creditors about two things: 1) recovery of the original loan asset; and 2) whether the purpose of the swap program represents (and achieves) interests of value to the creditor. In the case of official bilateral debt, these encompass the fiduciary and foreign policy obligations of governments to their citizens. In the case of a private creditor organization, these encompass responsibilities to their stakeholders, board, and legal authorities. The contribution of the four components to achieving these goals can best be appreciated by viewing them as part of an integrated system. As illustrated in Figure 3.1, for Russian debt for nonproliferation, the logic of asset protection is integrally connected to the flow of dollars and rubles on both sides of the swap agreement.

The process of asset protection is embodied in the two bilateral agreements. The Debt Agreement addresses the fiduciary obligation of the creditor by ensuring that fair value is received for the debt note. The Framework Agreement addresses in the case of official debt the creditor government's foreign policy obligation by defining the program in terms of its foreign policy interests. Implementation begins on the Russian side of the arrangement with the creation of the Russia Nonproliferation Fund and the appropriation of rubles. Program and Project Assurance are management elements designed to ensure that the required standards of openness, accountability and performance are met, and include numerous procedures and criteria to ensure

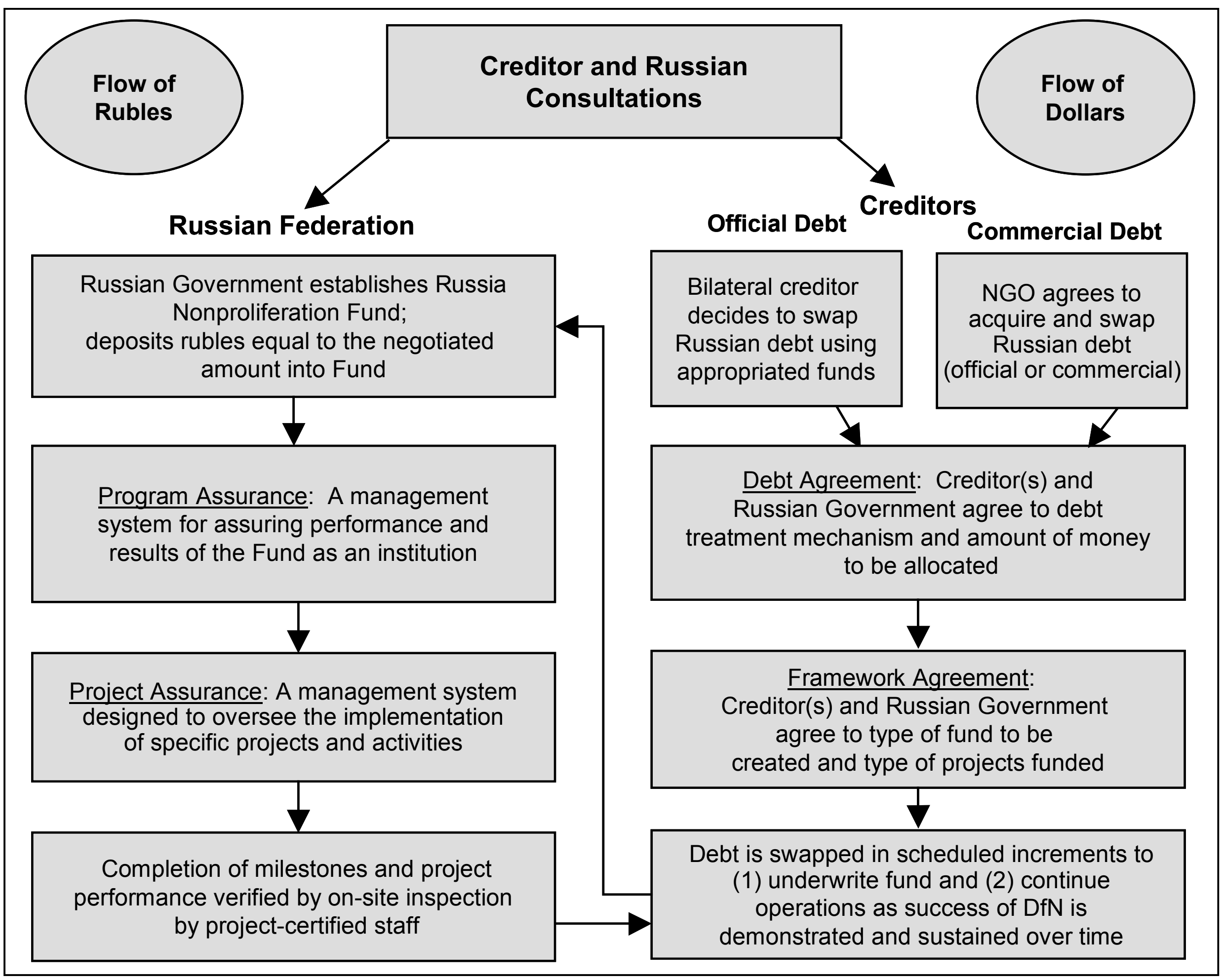

Figure 3.1 Asset Protection Based on Fundamental Elements

effectiveness and efficiency in operations. The long-term viability of the Fund will depend in good measure on the satisfaction of the creditor(s) that nonproliferation goals are being achieved in a timely manner and according to evaluation criteria contained in the Framework Agreement.

The authors have structured the discussion of lessons learned from the analysis of other Russian bilateral cooperative programs around these four structural components of asset protection. Again, refer to Figure 3.1 for a graphical summary.

Debt Agreement

Debt Agreement and *Framework Agreement* are terms borrowed from USAID. The term *Debt Agreement* pertains to that part of a bilateral contract that prescribes the choice of mechanism(s) to be used in swapping debt, whether rescheduling, buy-back, debt donation, three-party debt swap, or some combination of the four. It lists the specific loans that are to be combined and restructured under the agreement, along with the amount of local currency to be allocated. It also identifies the fund to which the proceeds of debt conversion are to be directed.[3.8]

With regard to USAID, debt swap agreements have been negotiated under provisions of the Enterprise for Americas Initiative (EAI) and Tropical Forest Conservation Act. Under these programs, nations can have their USAID and/or “PL-480” debt reduced by as much as 50%. Between 1991 and 1998, under the EAI program approximately $900mn in official USG debt was converted to create over $175mn in local currency funds in eight nations.[3.1] Since 1998, four nations have received debt relief under the Tropical Forest Conservation Act.

These provisions point to the fundamental difference between the treatment of official and commercial debt. Commercial debt is a private commodity that is traded on a secondary market in debt paper according to its fair market value. This is a market determination made on any given day. With official debt, net present value is a closely guarded secret. There is no international market in official debt paper, so there is no mechanism outside of government for determining its actual value. In the U.S. since 1990, short of some legislative provision, net present value is equal to the original face value of the loan.

For USAID or any other agency of the U.S. Government to negotiate a deal with a debtor nation in the restructuring of its official debt requires authorizing legislation. Congress must make a special exception in overriding a strict dollar-for-dollar interpretation of its fiduciary responsibility. For a variety of reasons, Congress will accept some monetary value less than the full face value of a loan in return for some good that Congress deems will produce a benefit of equal or greater value to American citizens. NTI should be in a very good lobbying position to promote Congressional acceptance of this approach for debt for nonproliferation.

As described in Chapter II, there are four mechanisms for converting (swapping) debt: buy-backs, write-offs, rescheduling, and tri-partite arrangements. NGOS can play an important role in all four. Tripartite agreements involving a creditor, a debtor nation, and an NGO features the most prominent role for NGOs. In this case, an NGO takes possession of the debt instrument and deals directly with the debtor nation in swapping the debt for a local fund. The role for an NGO in the other three mechanisms is more catalytic, involving facilitation to effect a debt swap in the context of a reduction initiative between creditor(s) and debtor.

Framework Agreement

Framework Agreement is a term that covers that portion of the debt negotiation where the design parameters and terms of conditionality of the program are specified. In point of fact every bilateral agreement must contain some functional equivalent to serve as a frame of reference in developing a program and evaluating its performance. What is unique about a Framework Agreement in its application to debt swaps involving an official creditor is the retention of some form of sovereign control by a creditor nation over assets used by a foreign government and its people on its own soil. This is fundamentally different from the construct and expectations of typical assistance programs. In a bilateral debt swap, a creditor nation retains an equity interest in the debt program because of the way it is created. The authors believe that this principle should also logically apply to a private creditor or NGO that may underwrite a private debt swap. When a debtor nation settles a debt by agreeing to trade a strict dollar-for-dollar accounting of value in favor of some other metric, numerous precedents suggest the debtor nation necessarily accepts the burden of an extra, non-fiduciary claim against its sovereignty. This expectation of shared sovereignty imposes a blending of control that is absent in other kinds of bilateral agreements.

In actuality this assertion of sovereignty by a creditor nation, or control by a private creditor, is tempered by other values that it also wishes to promote, and by some realities that in the case of debt for nonproliferation can make the assertion of control problematic or at least difficult. To foster creation of a self-sustaining program that in the long run serves the goals of the program, it is in the creditor's self-interest to promote some measure of autonomy in the fund's operation. The assertion of control must be handled with some care. It is also the case that where the security interests of a nation state are at stake and the object of collaboration is nonproliferation, there will undoubtedly be reluctance, if not resistance, on the part of a debtor nation such as Russia to sharing of control. This will be a challenge that must be anticipated.

A critical element of the Framework Agreement is to create a decision-making structure and process that is conducive to instilling trust in the bilateral relationship. This implies an organizational structure that the creditor views as virtually bullet-proof in its ability to produce program outcomes that are consistent with the terms of the debt agreement. To produce this level of confidence requires a decision-making process that is objective, transparent, and accountable. These are achieved by three structural mechanisms contained in the Framework Agreement and associated with the construction and operation of a Board of Directors: a board that is outside the direct control of government, particularly the debtor government; balanced board representation; and a rigorous project selection process. How each of these contribute to achieving objectivity, transparency and accountability in decision-making is described below.

Objectivity refers to decisions that are made on the basis of sound scientific, technical, and policy criteria, separate from the influence of special interests or domestic politics. The foundation of objective decision-making for funds is based on a significant degree of organizational independence from government. Foundations must be freestanding entities with their own corporate charter. Through Board membership, governments may execute policy influence but not have unitary authority over the fund. Structural separation precludes government from exerting direct line authority over the fund or otherwise viewing it as a government entity. This greatly diminishes the likelihood of debtor government subversion of the program. There are plenty of precedents for this constraint. USAID only creates foundations that are incorporated outside of the host government as an NGO. The Polish Ecofund was officially established by Poland's Ministry of Finance as an independent, non-profit foundation. Tax exempt status also helps in fostering organizational independence. This helps to remove any proprietary claim the host government may exert upon the foundation.

Board composition is a further refinement of the principle articulated above of creating objectivity by preventing domination of board decision-making by any single stakeholder. This is universally achieved among bilateral programs by striking a balance between domestic and foreign interests. USAID and the Polish Ecofund both carefully account for the interests of donor and host nations on the board. This representation ensures that all parties, both domestic and foreign, are informed about all projects proposed for funding, and have a direct voice in regulating spending policies through discussion and approval of annual financing plans.

In addition, funds also take steps to strive for balance among domestic government agencies and/or NGOs. This removes the likelihood of capture by a single domestic interest. USAID is required under the Rainforest Conservation Act to include representatives of universities and environmental NGOs on foundation boards. The Polish Ecofund balances the interests of the two government institutes primarily responsible for creating the fund, the Ministry of Finance and the Ministry of Environment.

Linking fund objectives to a prescribed framework of subject-specific priority sectors is another way of fostering objectivity in decision-making. Clearly defined priorities permit the use of rigorous eligibility criteria in selecting projects that fit within the scope and mission parameters of the fund. Decisions about the choice of projects must stand up against these criteria. While all bilateral programs identify problem-specific areas as part of their mission statements, the Polish Ecofund is perhaps the most instructive in this regard due to the thoroughness of its stated mission.

The Ecofund's objectives are clearly linked to national priorities specified in Poland's National Environmental Policy (NEP). Five problem-specific environmental sectors (in areas of air protection, water protection, global climate change, biological diversity, and waste management) are called out, along with several instrumental goals, such as transfer of innovative technologies from donor countries to the Polish market, providing *additionality* by supporting projects that would not otherwise be funded, leveraging of funds to capture additional resources, and maximizing cost-effectiveness. A third objective is stimulating development of the Polish environmental protection industry. These objectives permit the use of eligibility criteria that are extremely effective in screening out unqualified projects at the start of the appraisal process. Most project proposals (over 80%) are turned down because they do not comply with the Ecofund's criteria.

Transparency refers to a decision process that is a matter of public record and is open to scrutiny by public officials or their agents; the rationale and justification for decisions is subject to full disclosure; and stakeholders have access to policy deliberations and/or the decision-making process. Transparency in decision-making is closely linked to mechanisms for ensuring accountability. Structural independence precludes a host government from limiting access to the fund or otherwise influencing the dissemination of information and reports. Open access and the unrestricted dissemination of reports are crucial to proper monitoring and oversight of fund operations and decision-making.

USAID illustrates how these functions are served. Each year fund managers must submit a report to both U.S. and host governments describing three things: 1) progress for the past year; 2) work plan for the coming year; and 3) a financial audit. Audits must be performed according to international standards of accounting. Annual reports are submitted to USAID, which submits its own summary report to Congress.[3.8] The World Bank employs similar surveillance procedures. As with most bilateral programs, they require on-site inspections to verify completion of work.[3.9] All these measures require ready and unencumbered access.

For foreign stakeholders to truly have confidence in a fund requires both prescriptive and real time participation in fund operations. Prior to implementation, stakeholders need to know they have a voice in shaping the program and setting priorities. During implementation, they must have real time access to information about on-going activities and projects. This involvement occurs through board membership. For USAID, transparency is always a matter of trust, which starts with board membership. One U.S. representative on the board is sufficient to achieve this end. The purpose is not control, but to serve as the U.S. government's eyes and ears on the board. The Polish Ecofund illustrates what board involvement can mean to creditor stakeholders. Through board membership, all foreign governments are informed about all projects proposed for funding, and are able to influence spending policies through discussion and approval of annual financial plans.

Trust is also engendered by steps USAID takes to ensure that boards are authentic. Both for sake of transparency and to achieve its overall mission, the U.S. government actively strives to ensure that diverse domestic interests are represented on the board. As part of an on-going process of board selection, groups from different sectors (environment, universities, research organizations, etc.) are invited to nominate two candidates to represent their respective sectors. The host government selects one of the two. The slate of nominees is then presented to the office of the President of the Board of America's for final approval. The goal is to create a public/private board that is conducive to building a civil society/public sector partnership.

An open and trusted project selection process is another way of creating transparency. Such a process instills confidence among government oversight agencies that funds are being spent as intended based on objective decision criteria. Government oversight agencies are assured that funds are being spent as intended based on objective decision criteria. This process also instills confidence among potential grant applicants that there are uniform and objective decision criteria and procedures to which everyone must comply. In the Polish Ecofund, assurance is reinforced by a policy of providing applicants with a clear understanding of the grounds on which their application was accepted or rejected.

Accountability refers to a fund's adherence to, or deviation from, norms and expectations prescribed in the fund's mission statement and charter. Accountability is enforced through actions stakeholders may take to bring the fund into compliance. Compliance can be obtained by means of persuasion, negative incentives, or sanctions. USAID refers to the three measures available for enforcing compliance as "negative provisions." Their purpose is to negate decisions or actions that, in the view of government oversight agencies, do not conform to the policy mandate of the fund. Following each provision (below) is a brief description of how it is applied.

- The right of each government to notify the fund of a problem it sees and ask that it be fixed.

  This provision alerts the fund of a problem, with guidance on how government oversight agencies expect it to be fixed in order to bring the fund into compliance. Included in the Framework Agreement are provisions for amending the agreement at this relatively low level of concern, if necessary. These may include diplomatic notes or 'fixes" that do not require renegotiation of the contract.

- The right of either party to freeze accounts or declare that no new grants be awarded until a problem is fixed to its satisfaction.

  Provisions at this level of control may be referred to as "negative incentives." They offer tangible inducements to fund managers to prompt them to decide that it is in their best interest and the best interest of the fund to adopt a different policy or course of action. Essentially the ability of fund managers to act is taken away from them, either by freezing accounts or prohibiting the awarding of new contracts.

- The creditor reserves the right to liquidate the endowment, return funds to its treasury, and nullify the debt agreement.

  The most extreme form of intervention is reserved for occasions when it becomes clear to government oversight agencies that the situation is irretrievable. In this event the most severe sanction is applied. The endowment is liquated and assets are returned to their respective governments. In its history of managing debt conversions, USAID reports that it has never had to resort to this ultimate sanction. But, as USAID notes, the "string" to pull funds back has be there so parties are aware of what is at stake.

It may be worth noting that this most extreme form of intervention extends to the debt fund itself, and to any proceeds acquired through debt conversion that are as yet unspent. Whatever equity is created as a result of funds acquired through debt conversion obviously becomes the property of the debtor nation. There is nothing a creditor can really do to take back a good or service once it is produced. This points to the need for real-time participation on the part of the creditors in fund operations. In principle, the creditor may at any point terminate the fund and take back whatever proceeds are as yet unused. In effect this would mean reinstating the debt obligation at the level of valuation that remained when the debt agreement collapsed.

A second critical element of a Framework Agreement pertains to the philosophy and orientation that a creditor brings to the formulation of a debt fund. This defines those intangibles that ultimately play a decisive role in the determining eventual success of the program. Most developing countries begin the process of creating a fund with a blank slate. USAID defines Russia as a country in transition rather than a developing country per se. Nevertheless, USAID views Russia as being subject to the same constraints and limitations as developing countries when it comes to the development of funds. For example, Russia has little or no experience with foundations since for the most part foundations originated in countries where individuals were able to amass large amounts of money and needed an efficient method of giving it away. Consequently, creditors will need to take special care to set in motion an engagement and program development process that is conducive to creating the type of values, goals and interactions it hopes to foster.

USAID, INSP, and CTR present three quite different models of engagement to choose from in constructing a debt fund in Russia. These are the ownership model, the negotiated ownership model, and the compliance model. The differences in large part are due to the focus of each of the programs. These range from environmental preservation to nuclear reactor safety to the disposition of nuclear weapons and materials. They inherently require different engagement approaches. Still, it is useful for debt for nonproliferation to take into account the different options that are available so that it can be proactive in choosing the model, or model hybrid, that is most appropriate to its specific purpose. The significance is that the approach to engagement defines general assumptions underlying the application of different project control and assurance mechanisms.

The USAID orientation to engagement is unreservedly inclusive in its approach to fund development, i.e., represents the ownership model of engagement. It places a premium on promoting democratic ideals and institutions through local ownership. Foundations should be civil society organizations that try to involve as many people as possible. Countries are pushed by USAID to create boards that include not just government ministers but also people from many different groups and sectors. Domestic ownership is encouraged by a U.S. policy of avoiding micromanaging and by encouraging the development of local expertise through networking among foundations from different developing countries. The entire process of bringing public and private sectors together to create a joint vision has enormous value in its own right. Even if this process plays out over a period of months, giving participants time to develop a core set of values will have lasting impact on the success of the program. Essentially what is often at stake is the creation of a whole new developmental paradigm for the country.[3.8]

INSP approaches collaboration with Russians from the perspective of a negotiated ownership model of engagement. Local ownership is encouraged but is conditional on the acceptance of certain project mandated practices and procedures. They do this for two reasons. First, to achieve its mission of improving reactor safety and reducing the risk of accidents, INSP managers felt it was necessary for operators to be able to recognize the risks and take steps to mitigate them. INSP could not just tell the Russians to do so if they did not understand what was expected, accept the rationale, and take responsibility. Second, they assumed that host country buy-in was essential for leaving Russians with a self-sustaining infrastructure that would allow them to continue after U.S. funding ended. Nevertheless, INSP managers encountered considerable resistance on the part of Russians. Two obstacles in particular were the culture of suspicion and secrecy that Russians harbor toward the U.S. as a result of a history of Cold War hostility, and the increased bureaucracy that comes with anything having to do with security there. Engagement leading to ownership was a negotiated process that unfolded as Russians became more confident that advantages were not all tilted toward Americans but that they had something to gain as well. Most interactions were adversarial in the beginning but became more cooperative.[3.10]

CTR is a performance-driven program with specific outcome goals, i.e., represents the compliance model of engagement. It contracts with American, international or FSU or Russian firms to complete specific tasks and as such, it does not depend on local ownership as a prerequisite to building long-term program capacity for its success, but local politics and support can play an important role in the success or failure of a specific project. In a conversation with a former CTR project manager, the authors learned that CTR is concerned primarily with compliance and seeing that the items and services provided are being used for their intended purposes and that they are intact, secure, and satisfying the legislatively mandated goals of the CTR program. Nevertheless, as a cooperative program, it depends on Russian participation to accomplish its goals. The relationship between Russians and Americans may be characterized as adversarial in some cases. This is due to several factors. First, most of the work occurs on military facilities or defense industry facilities with access under direct control of Russians. If they don't like something, they can and do refuse access. Second, the audit and examination protocol is like an arms control inspection protocol. When it comes to execution, there can be interpretation involved, which can be exploited. Third, in some cases, U.S. audit teams are led by arms control inspectors; CTR project managers play a supporting role. Russians often responded to the presence of arms control inspectors in a formalized and adversarial manner.

The three engagement models point to the need for the U.S. side to be clear about its program expectations. There are perhaps two sets of goals about which it must be especially clear. One is whether, or the extent to which, it wishes to pursue infrastructure development aimed at economic diversification and nonproliferation sector capacity building; target projects with direct nonproliferation application and outcomes; or some combination of the two. The second is the whether, in relation to closed cities, confidence-building and transparency remain goals in their own right, or whether bilateral relations have progressed to the point where these broader goals are no longer an issue.

Program Assurance

In the following analysis the Polish Ecofund is presented as a model to follow in constructing program and project assurance systems. This is done for three main reasons. As discussed below, the Polish Ecofund itself is modeled after a category of environmental funds specifically designed to compensate for the institutional and market failures endemic to planned economies. Second, the Ecofund is endorsed by governments and institutions that matter: the U.S. government is the fund's largest contributor, and as noted earlier, the OECD describes the Polish Ecofund as a model institution. Third, the systems of program and project assurance the Ecofund employs are rigorous, rational and thorough.

The Polish Ecofund is a type of financial instrument known as an *environmental fund*. Environmental funds emerged in Eastern and Central Europe following the breakup of the Soviet Union and were designed to assist economies in transition from planned to market economies. They served a dual role of improving the environment while introducing sound financial accounting and program management practices in countries suffering from a legacy of institutional and market failures. The Polish Ecofund was the first environmental fund in Central and Eastern Europe devoted specifically to debt swap. Most environmental funds are revolving funds that are sustained by revenues from pollution charges, environmental fees and other dedicated accounts. The Polish Ecofund adheres to two complimentary program and project management systems: a program cycle and a project cycle embedded within it. These are depicted in Figure 3.2 for the typical environmental fund.[3.11]

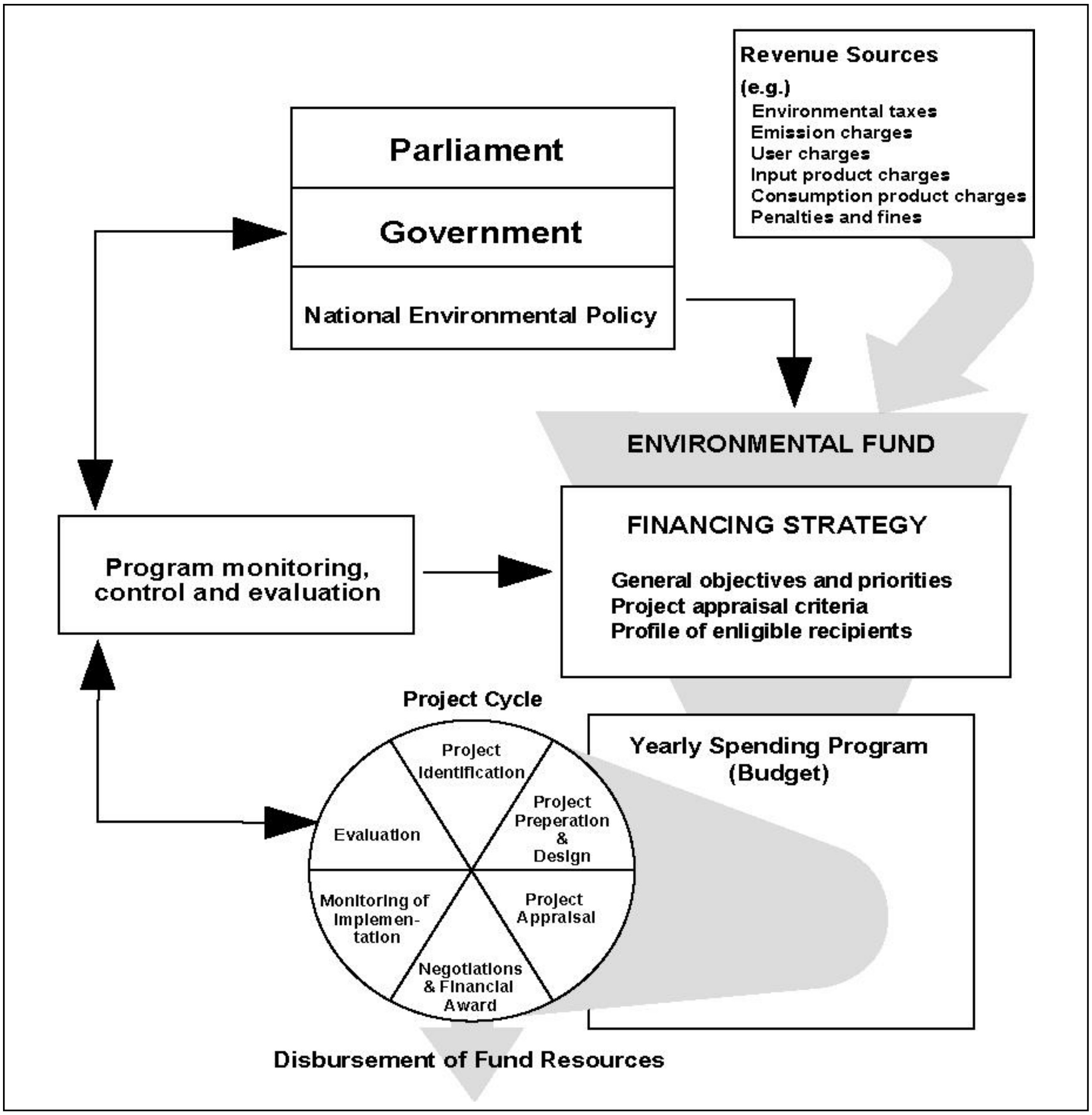

Figure 3.2. Outline of a Program Cycle in an Environmental Fund [3.11]

A program cycle defines a management system that is responsible for the overall performance and results of the environmental fund as an institution. Its purpose is to promote efficiency in the allocation of funds by matching expenditures to policy priorities. Ideally policy priorities are derived through a political process external to the fund itself. These priorities are articulated in the form of a “financing strategy.” The financing strategy serves several critical functions, including linking funding goals to national policy and providing clear guidance for developing the fund’s spending programs. These criteria include such requirements as cost-effectiveness, environmental effectiveness, and technical proficiency. The process of matching expenditures to policy priorities occurs in the formulation of an annual budget. The budget process serves as a primary control mechanism for ensuring efficiency and effectiveness in the implementation of projects.

A project cycle (described more fully in the next section) defines a management system that is responsible for overseeing the implementation of individual projects and activities. It is structured around the elements of the project development cycle, from project identification to implementation to evaluation. While the project cycle places special emphasis on principles of rational planning, it is especially oriented to ensuring objectively, accountability, and transparency in fund operations. Planning in every stage is based on written criteria and procedures that do not change erratically and are available in advance to all applicants. Because careful analysis of alternatives was an area of neglect under central planning, project identification and design stages give special attention to defining an array of technically and economically feasible options.

As a category of environmental funds, debt swaps often employ a variety of administrative structures to achieve these two complementary management functions. Most administrative structures employed by debt swaps are a variation on one of two fundamental models: a one-level structure, or a two-level structure.[3.12]

The two-level structure is the most common. It divides management functions into two separate bodies: a *board* (sometimes called a *governing board,* or *supervisory committee,* or *bilateral committee)* and an *implementation team* (sometimes called a *technical committee*). The Board consists of representatives of the two (creditor and debtor) governments, and is typically the fund’s ultimate decision-making authority. It has final authority over project selection and funding. Creditors may share authority equally with the debtor government, or the creditor government may retain ultimate decision authority. The Implementation Team is responsible for inviting proposals, reviewing them, and submitting them to the board for final approval. National and International NGOs on the Implementation Team often perform much of the day-to-day work. In some cases, NGOs on the Implementation Team are given real decision-making authority, in which case approval by the board serves as a formality.

The one-level structure differs from the two-level structure in the emphasis it gives to private sector and NGO participation. Both government and non-government players sit on a single *administrative committee* and share equally in project selection and funding decisions. The administrative committee invites proposals and revises and approves them. Some of the more technical tasks associated with the process may be delegated to member NGOs, state agencies, or independent institutions. Some examples of one- and two-level administrative structures are provided below.

Figure 3.3 depicts a one-level structure that is the basis of the Swiss Counterpart Fund (CPF) for the Philippines. The Fund is characterized by broad NGO participation on a single administrative committee. This arrangement is supported by Philippine Local Government Code which assigns broad NGO influence in the design and implementation of local projects. At a national level, the Swiss interact with an umbrella organization of NGO networks that represent the fund, the "Caucus of Development NGO Networks (CODE-NGO). It has defined its role broadly in representing a wide spectrum of Philippine NGOs.[3.12]

Figure 3.4 presents the Swiss Counterpart (CPF) structure for Peru. This is a typical two-level administrative structure where ultimate decision authority resides with representatives of the two governments on a bilateral committee. The two governments are represented by the Ministry of Finance of Peru and the Swiss Embassy in Lima. The technical committee, responsible for review of proposals and day-to-day management of the fund, is comprised of several Peruvian NGOs.[3.12]

Figure 3.5 shows a typical administrative structure under the USAID "Americas Fund." The structure represents a hybrid of the one- and two-level administrative structures. In appearance it resembles a one-level structure because representatives of the two governments share decision-making authority on a single Administrative Council

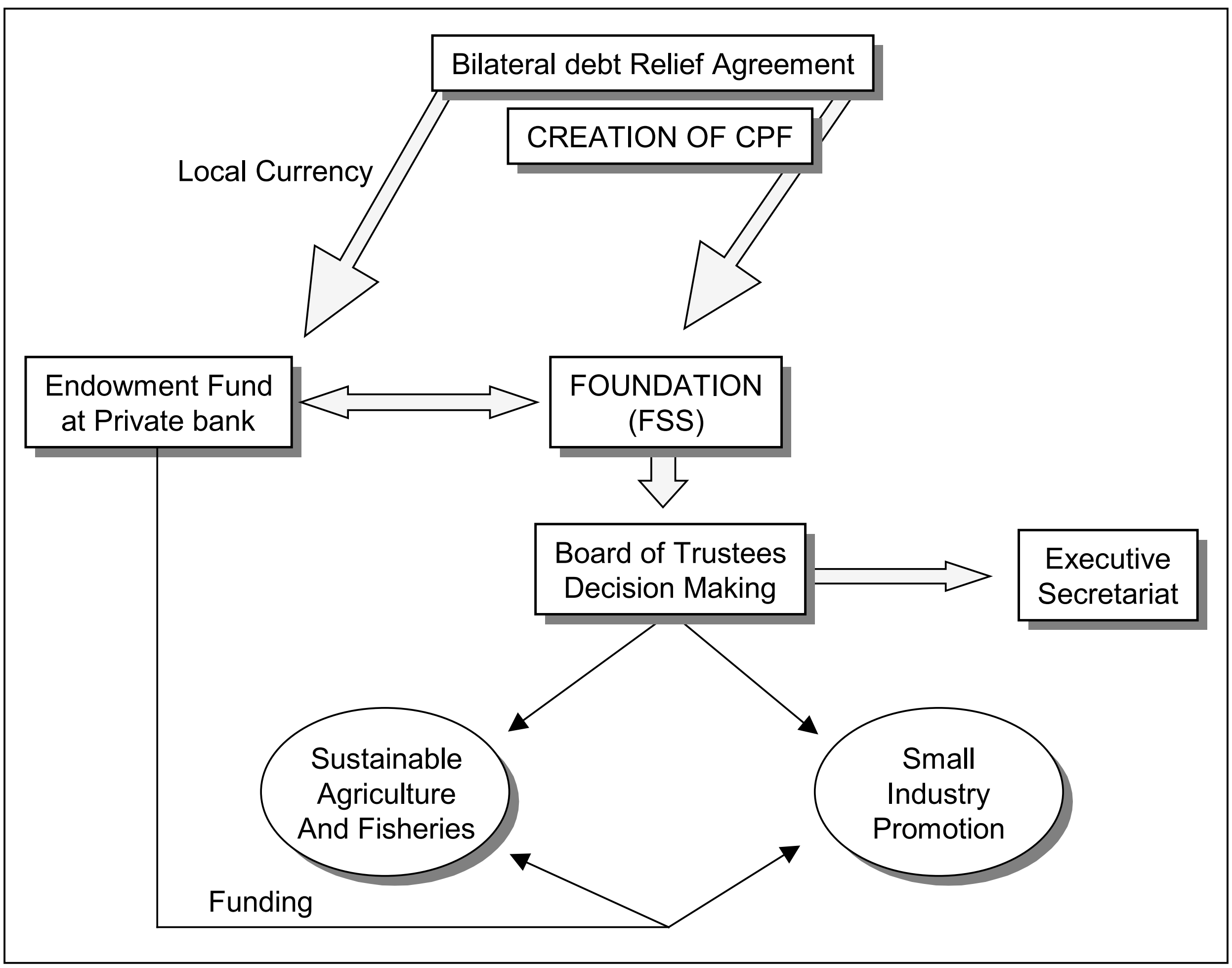

Figure 3.3 Swiss/Philippines Example of a One-Level Fund Administrative Construct [3.12]

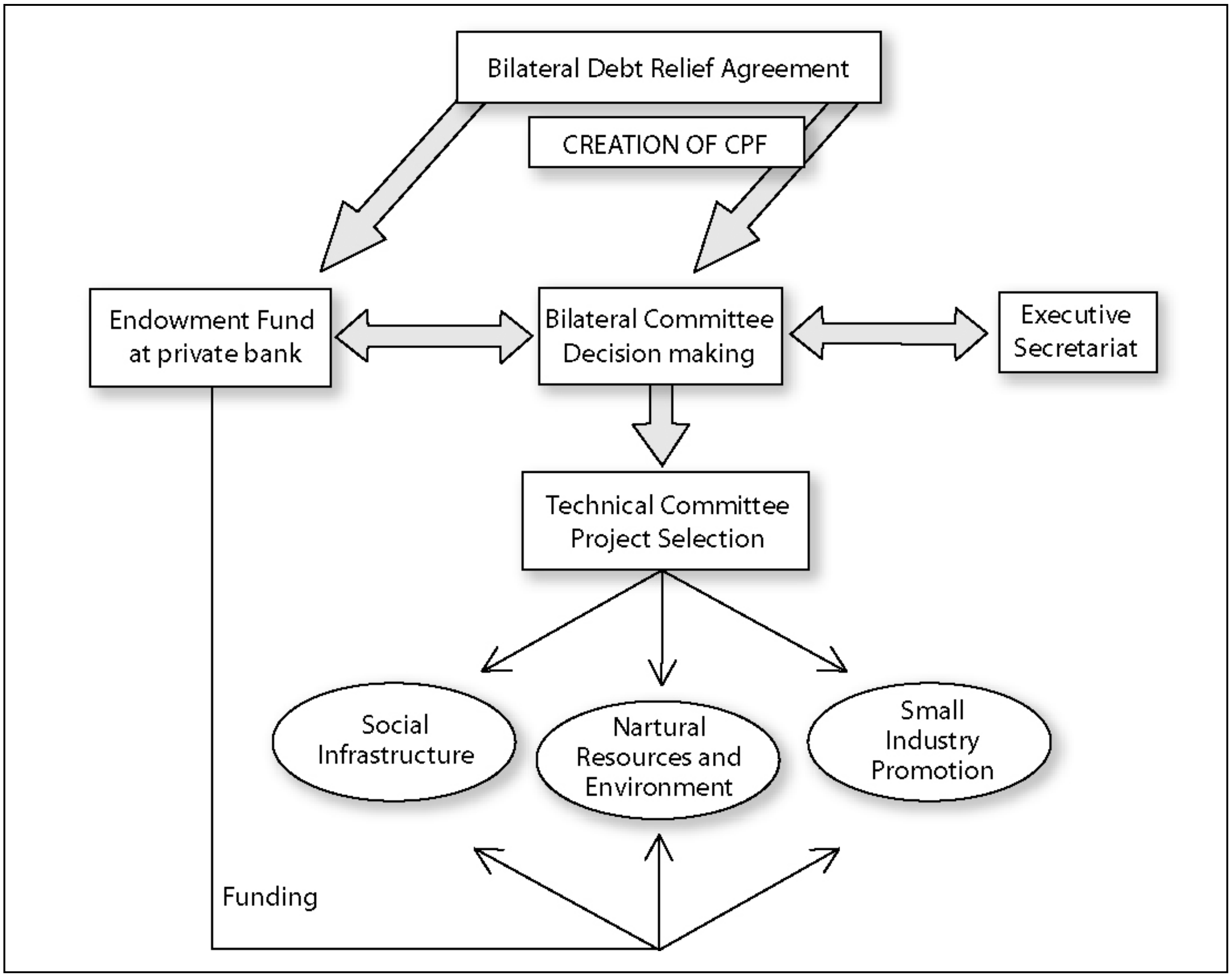

Figure 3.4 Swiss/Peru Example of a Two-Level Fund Administrative Construct [3.12]

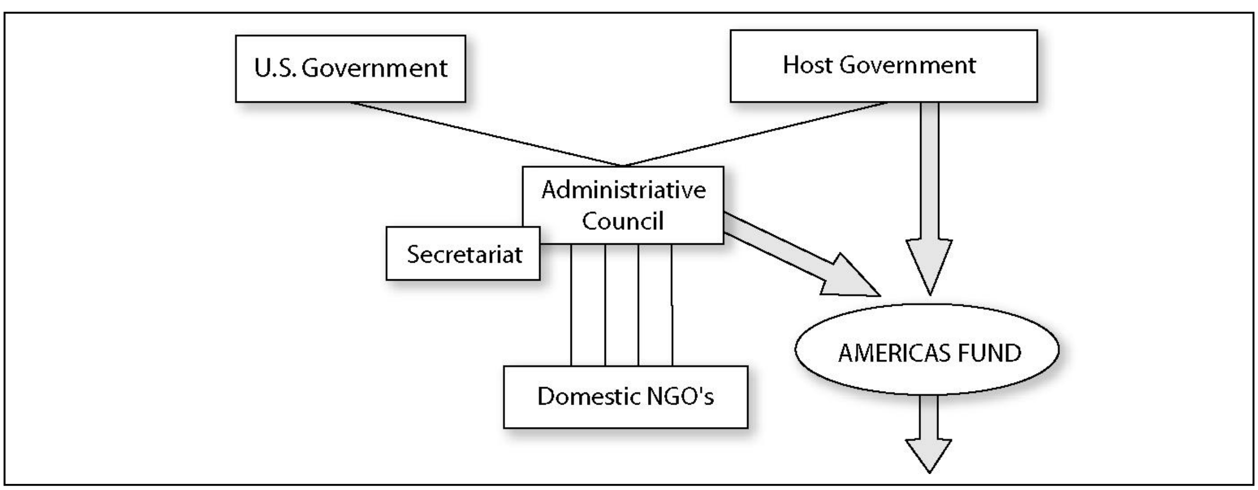

Figure 3.5 USAID/Americas Fund Example of a Two-Level Fund Administrative construct [3.12]

with local NGOs, representing environmental, university and other key sectors. In structure the two governments retain a superior position over NGOs. Governments have final say over the choice of NGO representatives to sit on the administrative council, and the two governments may veto any project if it exceeds $100,000. In actuality, these provisions are rarely exercised and exist to allow the U.S. Government primarily to make sure that funds are authentic civil society organizations and that projects serve goals of environmental preservation.[3.12]

Figure 3.6 presents the administrative structure of the Polish Ecofund. This is an example of a two-level administrative structure where the governing board is associated entirely with sponsoring governments. A *Supervisory Council* is comprised of representatives of the two primary Polish government oversight agencies, the Ministries of Finance and Environment, plus representatives of governments that contribute to the fund. The Council's main responsibilities are to:

- define the Ecofund's general policies concerning, inter alia, program priorities, project selection criteria, eligibility and procedures for awarding grants;
- examine funding proposals put forward by the Management Board;
- make final decisions on awarding grants to projects proposed by the Board;
- approve project implementation and annual reports submitted by the Board;
- appoint or dismiss members of the Management Board, and;
- determine the duties, responsibilities, and remuneration of the Board.[3.4]

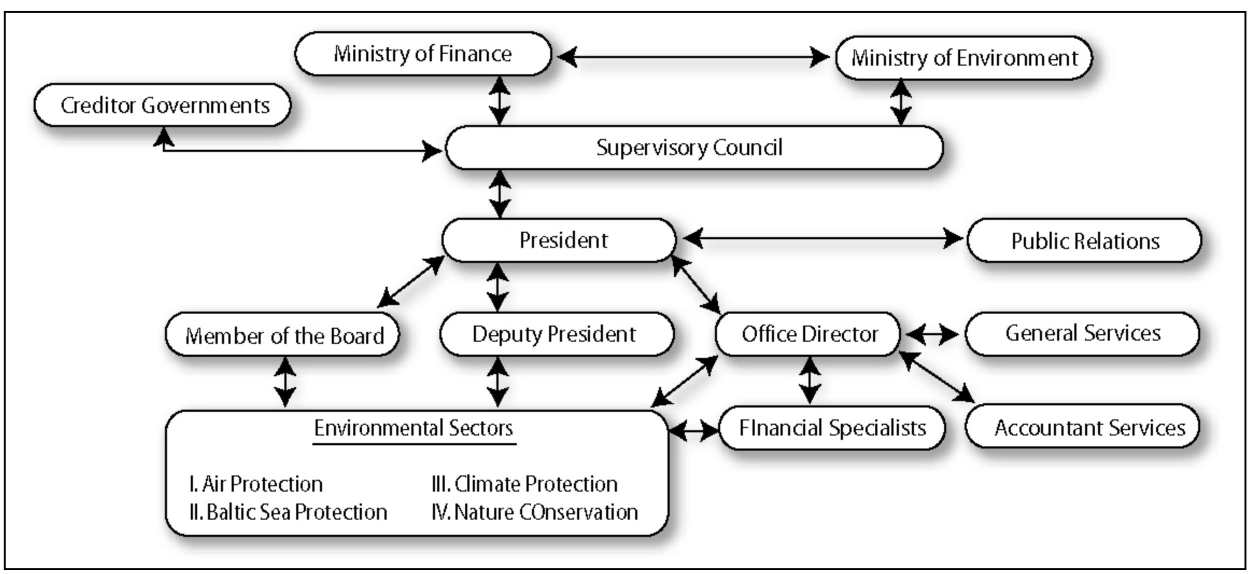

Figure 3.6 Polish Ecofund Example of a Two-Level Fund Administrative Construct [3.4]

A Management Board forms the second tier and is positioned beneath the Supervisory Council. This Board is under the formal direction of a president and serves as the implementation team of the fund. The Board is a professional body consisting of two to five persons, appointed to three-year terms. It is responsible for managing the fund's day-to-day activities, including:

- project appraisal and initial project selection;
- preparation of project applications to be submitted to the Council for consideration;
- conclusion of grant agreements for projects approved by the Council;
- monitoring of expenditures on projects which are under implementation;
- insuring proper and timely completion of projects by grant recipients;
- preparation of annual reports and evaluation of completed projects, and;
- external/public relations.[3.4]

Project Assurance

Project assurance refers to a system of management designed to oversee the implementation of specific projects and activities. We do not envision the Russia Nonproliferation Fund staff managing projects on a day-to-day basis, instead it will award contracts to Russian government and private contractors to perform this task in concert with the performance of the actual work. The task of the Fund really is to manage those who manage projects. This assumes a comprehensive system of monitoring and evaluation to provide direct oversight and objective verification of completed work. The purpose of the project assurance system is to ensure that the governing board and implementation team have sufficient information to make informed decisions about the choice of projects and awarding of contracts; to ensure that work is completed according to predetermined parameters covering scope of work, schedule, and costs; and that completed work conforms to predetermined design specifications.

The system of project assurance is structured around the elements of a project development cycle as outlined in Figure 3.2. The *project cycle* refers to the process and procedures for identifying, preparing and deciding on projects. In the following series of templates each of the elements is defined and then assessed in terms of the experience of the debt swap and threat reduction programs at the core of this analysis. Definitions are derived from the literature on environmental funds. In some instances assurance processes at the program level are also discussed. This is because the two systems are intrinsically interrelated, and decisions made at the program level will invariably affect the choice and application of control parameters at the project level. In order to promote transparency in fund operations, it is typical of environmental funds to make these procedures and the criteria used for project appraisal available to the public and potential applicants in writing.

Project Identification and Preparation. Applicants must prepare a proof-of-concept or pre-feasibility study to show 1) that the proposed project conforms to the priorities and selection criteria of the fund, and 2) that the proposed project is economically and technically feasible.	
Ecofund	Ecofund uses direct meetings and training workshops to identify projects and inform potential applicants of priorities and eligibility criteria. The fund employs both passive and pro-active strategies to identify projects, relying on unsolicited proposals and proposals solicited through focused competitions.
USAID	USAID takes a flexible and interactive approach to working with countries to build a strategic plan as a basis for identifying projects. This is part of an overall process for building a fund, and follows creation of a board and administrative staff. Program goals and priorities are typically based on intensive consultations with key stakeholders in target regions. Projects must conform to priorities and eligibility criteria established through this process
INSP	A joint coordinating committee comprised of senior U.S. and Russian managers was formed to allow members to examine their respective priorities as a basis for identifying projects. The meetings produced some give and take and compromise. Some of what Russians wanted to do had more to do with improvements in operations than with safety, while other suggestions were directly useful. INSP worked hard to make sure that Russians perceived a mutual benefit to participation.
CTR	Discussions of new projects most often begin with high-level U.S. and Russian policy makers and program managers. A U.S. technical team is then brought in to further develop the concept. It is usually never advisable for the Russians to take the first cut at defining base assumptions and scope although in some cases this is necessary because of the complexity and process involved. It is better if they comment on what the U.S. side produces first, to indicate if it is intelligible, makes sense, and if there are any adjustments. The reason being many of the personnel CTR deal with have little experience developing projects from the ground up; usually what they bring is one person's agenda or limited perspective on the requirements. The next step is to bring together working level people from both sides, plus management. Russians are likely to say that they are capable of doing anything. The challenge is to get actual project-level staff from both sides together to discuss details and agree on rational and realizable action plans. Sometimes this requires setting up a side meeting of actual project doers to accompany formal discussions.

Project appraisal. This involves an assessment of the technical, environmental, economic, and financial aspects of projects to make sure the most effective projects are financed and that costly failures are avoided. Fund managers and project applicants work through in detail the necessary implementation arrangements and relationship of the project to an array of parameters, including financing, procurement procedures, legal impediments, etc.	
Ecofund	Environmental, technical, economic and financial aspects of project applications are examined by Ecofund's in-house staff. Applicants are required to specify the objectives and rationale of the project, document the proposed technology and anticipated environmental benefits, provide information on proposed contractors/suppliers and procurement procedures, include a project performance (and time) schedule, present an economic and financial analysis, and provide any other supporting documentation, including an Environmental Impact Statement. In addition to eligibility criteria, scoring systems are often used to compare and rank similar projects. Large and complex projects are typically evaluated by independent experts/consultants commissioned by the fund. Projects that receive a positive evaluation by the Board are submitted to the Supervisory Council for final approval, where a two-thirds majority vote is required.
USAID	Funds rely on in-house staff or hired contractors to invite proposals and review them for technical and environmental qualifications. Proposals are submitted to the Board for final approval.
INSP	Before projects are awarded, work is broken into specific activities or products, each with its own work plan. The monetary value of the work to be performed is determined along with control parameters covering scope of work, schedule (including deliverables and/or milestones) and cost. Cost and control parameters are first defined by INSP staff, based on the cost of doing similar work in the U.S. or comparable countries. This provides a realistic baseline against which to compare Russian estimates and negotiate final amounts. Applicants must submit a project performance schedule along with a complete economic and financial analysis. Activities to be performed by the host country (as opposed to outside contractors) are identified along with those activities falling outside the scope of what the program will fund and which must be financed from other sources.
CTR	Implementation of each project is guided by a general umbrella contract and implementing contract. The agreements include a comprehensive audit protocol. It has proven essential to devote a lot of time to the technical requirements or statement of work, going through it up-front, line-by-line, to make sure everything in it is understood by all parties. The more that is understood and agreed to in advance the more it will pay off later. Any misunderstanding usually come back as problems later. This includes such things as access to restricted areas. Access requirements not included up-front in the requirements may be denied or delayed. For example, any photographs, documents or access needed to verify progress or completion of work needs to be negotiated in advance.

Negotiation of Grant Agreements. The final stage of project preparation is negotiation and approval of the project and financing. All issues on details of the project, recommendations of sponsors resulting from the appraisal process, and financing terms and schedule must be resolved before documents are signed.	
Ecofund	The Council's decision to approve a project remains in force for six months, during which time the Management Board negotiates the contents of the agreement, specifying which parts of the project the Ecofund will finance, a final procurement schedule and timetable for all stages of financing. All equipment and services must be obtained according to international tender rules and may be provided only by suppliers from donor countries and Poland. All permissions necessary for the project to proceed must be obtained, and the project must be fully funded with all sources of funding in place.
USAID	Along with technical and environmental considerations, Boards take a number of qualitative factors into account in selecting proposals, such as maintaining an equitable distribution between large and small NGOs, and making sure that proposals are distributed equally across regions of the country and between the capital city and rural areas.
INSP	Most contracts are firm fixed-price so there is not a lot of room for negotiation. The U.S. side produces its best estimate of scope of work based on the number of person-hours required to do the job in comparable countries where the team has access or prior experience. INSP presents the Russians with an offer and there may be slight adjustments up or down but nothing too dramatic. Early in the project the arrangement was for the U.S. side to provide the hardware and the host country to cover the work. Later because of financial difficulty in host countries the U.S. stepped in to help with labor costs. This required some adjustments and negotiations.
CTR	In working with FSU Contractors (only if project is to be done by FSU contractor), it is important that payments are tied to a deliverable or completion of a milestone and the contracts are firm fixed-priced. In most cases, FSU contractors do not get paid until CTR staff or designated representatives verify completion of work. The FSU contractors sometimes may take out a bank loan to cover work in advance of payment, or work for nothing until they get paid. Getting payments to the FSU contractor through the FSU banking system once work is completed can be difficult and sometimes is delayed. This verification of work performed is tied to the specific contract and is in addition to the audit and examinations allowed under the umbrella and implementing agreements.

Project Implementation and Monitoring. Projects must be carefully monitored during implementation to safeguard the fund's resources, ensure obligations under the agreement are met and to facilitate implementation.	
Ecofund	Projects are divided into discreet implementation stages with payments made according to an agreed schedule against proof of purchase or agreed project milestones. Progress is monitored by on-site visits by Ecofund staff, or on large and complex projects by independent consultants. Failure to comply with the terms of the agreement can result in termination of the contract, with the contractor required to reimburse the Fund the full amount plus a penalty.
USAID	Monitoring by USAID is calibrated to the foundation's stage of development. Prior to signing a cooperative agreement with USAID, a foundation must demonstrate a certain level of organization and competency to meet USAID's "grant-worthiness." For the first few years USAID closely monitors operations to offer assistance in developing the technical and financial competency of staff. After the first phase USAID relies on annual reports and audits to track progress. At the foundation level, projects are assessed through site visits by program managers and by annual reports.
INSP	PNNL is the Managing Integrating Contractor (MIC) for INSP. The role of the MIC is to manage those who manage projects. Two systems are used to monitor costs, track performance and oversee day-to-day operations of the program. An Integrated Procurement Assessment Program (IPAP) tracks subcontracts and procurements. A Financial Data System (FDS) tracks all costs against all charges on each project. Projects are periodically *rolled up* to compare costs-to-date with allocated funds and funds received. Verification of completed work occurs throughout the project, using procedures and schedules agreed upon beforehand and appropriate to each task. Verification always involves on-site inspections by project-certified experts. Payments are made on an agreed schedule against proof of purchase or accomplishment of agreed project milestones.[3.13]
CTR	In audit and examinations procedures, the legal regime governing assistance to each FSU recipient includes agreements that provide for the audit and examination (A&E) of goods and services provided. In most cases, the audit is conducted under the auspices of the responsible FSU ministry. Step One is notification of the FSU country of the audit. Step Two is a pre-brief at the ministerial level, where the visit may be denied or postponed. In Step Three, the ministry provides the U.S. team with their inventory of items that is crosschecked with the CTR inventory and records. Step Four is a site visit by U.S. inspectors, in some cases accompanied by a ministry representative. Step Five is an examination of the equipment and records to verify serial numbers, etc. with the CTR records. A benefit of the on-site visit is that locals are able to voice their compliments, problems or complaints about the project. Step Six is an informal out-brief to the local site manager to inform him what will be reported at the ministerial level. Step Seven is a formal out-brief with the ministry, with versions of the report prepared in English and Russian. The ministry adds its comments and signs the report, which is an acknowledgement of receipt and not agreement. Complaints by the ministry in some cases are sent directly to the U.S. Embassy or State Department.

<table>
<tr><td colspan="2">Evaluation of Implemented Projects. The project cycle concludes with evaluation of project results. This should include an evaluation of the fund’s internal operations during the project cycle to serve as a critical learning device and tool for capacity building.</td></tr>
<tr><td>Ecofund</td><td>Upon completion of the project the grantee must submit a final report covering the entire project, its ultimate cost and environmental benefits. Endorsement of the report is subject to a positive evaluation by the Ecofund Project Manager. A final evaluation is made by the Management Board, with a general conclusion prepared for the Supervisory Council.</td></tr>
<tr><td>USAID</td><td>Evaluations cover both process goals such as organizational capacity building and public awareness and outreach, as well as actual environmental impacts. Evaluations across countries are not as standardized as USAID would like, and this year a new form is being used to try to bring more uniformity to the evaluation process and outcome measures.</td></tr>
<tr><td>INSP</td><td>Projects are evaluated throughout the project according pre-determined criteria, including a baseline schedule of deliverables, milestones, costs, etc. Every month INSP staff send each project a “call status” to track performance against the baseline schedule. Projects that get out of synch are brought to the attention of the project manager. Among the lessons learned by INSP:
• Balanced but aggressive management
– All the old truths apply in Russia as well (trust, but verify; mange by walking about; the devil is in the details, but so is salvation
– Make the processes work toward the end
• Constancy of U.S. purpose
– International Agreements
– Unwavering senior commitment to breaking barriers as they appear
• Constancy of Russian Federation purpose
– Must address the Russian Combine’s conflicting objectives.[3.14]</td></tr>
<tr><td>CTR</td><td>In audits of implemented projects, most discrepancies occurred in paperwork and were able to be corrected on-site. The majority of sites were compliant most often. Serious discrepancies that surfaced were discussed at the ministerial out-briefing and were handled through an exchange of diplomatic letters, between CTR managers and the Russian ministry. Managers would notify the Russian ministry of the discrepancy and that they were expecting a response. Among the lessons learned from CTR:
• Be precise in prescribing the structure of audits and examinations in the agreements and verification provision in contracts with FSU contractors.
• The background and make-up of the audit teams are important.
• Make sure in any audit and examination agreement all parties responsible for a project such as ministry representatives participate in all aspects of the audits; this may mean budgeting travel funds for the FSU participants.
• Preventing "scope, cost, and schedule creep" is very difficult and a constant source of contention. U.S. teams coined the phase "the Russia Factor" which means when planning to take any estimate and multiply it by a factor of four. When it comes to “creep”, a Russian ploy is to threaten to delay or threaten failure of a project unless additional resources are provided. In many cases, the additional resources requested were originally agreed to have been provided by the Russians. CTR must then decide whether to shut the project down or take on the additional scope.</td></tr>
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A Model Framework for Russia Nonproliferation Fund

There has never in history been a debt swap between sovereign equals. No matter that Russia is considered a transition country, or that its economic plight puts it on a second or third tier in relation to its G-8 partners. The fact that Russia is a nuclear power and has a standing army of consequence, by definition makes it the sovereign equal of the United States. This could add a layer of complication to the construction of a multiple-stakeholder-managed debt swap fund, a fund for which there is no precedent.

There is nothing inherent in the structure of a debt swap fund that defies the realization of acceptable standards of transparency, objectivity and accountability. The structures and procedures for protecting the fiduciary and foreign policy interests of creditor nations are well understood and readily implementable. A real challenge of debt swap around nonproliferation will be dealing with the issues that define the sharing of power in an unequal relationship among equals. For Russia to engage in debt swap similar to the models described previously, it must be willing to accept a claim against its sovereignty that may seem to render it subservient to its sovereign peers. Never mind that the arrangement is mutually advantageous or that it is a positive step that Russia can take on its own behalf to serve its vital economic and domestic needs. At the end of the day the unequivocal reality is that Russia is openly and demonstrably permitting a sovereign nation to share in decisions over the disposition of its security and foreign policy assets.

This arrangement will need to be handled with some delicacy and care. In this regard there are a few lessons that can be taken from the above analysis. In its own way, each of the three engagement models is inadequate to meeting the challenge of debt for nonproliferation. At the two ends of the continuum the ownership and compliance models seriously misrepresent the central role of partnership in a debt for nonproliferation bilateral relationship. The ownership model is wrong because the creditors cannot just put a process in motion and monitor passively from a distance. The compliance model is wrong because it is antithetical to the building of partnership. Yet elements of both models must be present in any calculus of engagement.

The negotiated ownership model comes closest to describing what is required but its application to INSP is too far a-field from the mission of the Russia Nonproliferation Fund to render it entirely meaningful or satisfactory. At its base, INSP is a hierarchical relationship with Americans in a superior position due to their money, knowledge and expertise. There is not a true sharing of power in decision-making or program operations. It may be that true power sharing is something that creditor nations will in the end decide is not something they wish to entertain. (Germans speak of *control* of fund assets as a condition of debt swap, for instance.) Then the question of Russian agreement to the program and eventual buy-in becomes an issue. But if the U.S. is serious about using the proceeds of debt swap to build capacity in support of a program of jobs creation and nonproliferation sector development, then it will of necessity need to pursue of program of action that is both visionary and inclusive.

Consequently, to serve its multiple obligations and purposes, the Russia Nonproliferation Fund must be based on a partnership where power is authentically shared, it must be efficient and effective in its management and operations, and it must be fully accountable. Elements of all three engagement models must be employed:

the active pursuit of a shared vision and commonality of values to foster shared ownership and mutual buy-in; the use of money, education and training to produce incentives for change through self-directed action; and when necessary, hard-nosed bargaining and negotiation with the use of sanctions to enforce compliance.

Figure 3.7 presents a model framework for a Russia Nonproliferation Fund based on a structure capable of accommodating the multiple obligations and purposes the fund will be called upon to perform, plus the various engagement strategies that must be employed to achieve them. The fund would be established as a legal entity within Russian and serve as the ruble account from which grants are provided to accomplish projects that serve nonproliferation objectives of the participants. The Fund would have as a fundamental component a stakeholder governance structure to assure maximum transparency and accountability. It would employ an implementation team modeled after technical committees found in environmental funds to bring economic and technical proficiency to fund operations. The structure of the fund would be sufficiently flexible to accommodate swaps of either bilateral or commercial debt. The numbers in the diagram correspond to the following explanatory notes.

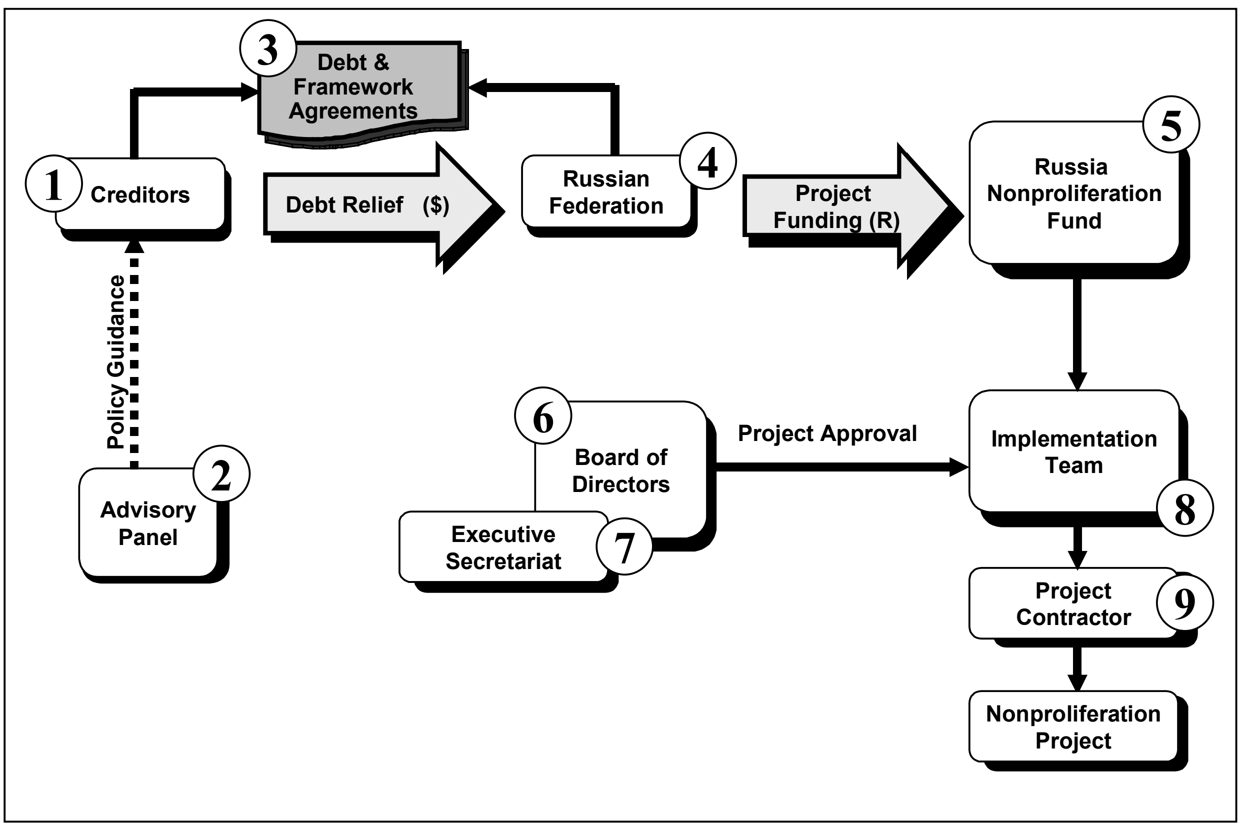

Figure 3.7 A Model Framework for a Russia Nonproliferation Fund

1. Creditor(s): either consider a Russian proposal to convert hard currency debt for the establishment of the Fund, or initiate consultations with Russia on a debt for nonproliferation swap reduction/restructuring.

2. Advisory Panel: a group of knowledgeable specialists from the environmental NGO, nonproliferation, and governmental financial communities to guide in the formation of the Fund by the creditors and Russia.

3. Debt and Framework Agreements: constitutes the specific contractual-like conditions for debt reduction and Fund implementation. There would likely be a series of bilateral agreements between each contributing creditor and the Russian Federation. The agreement would define the rate of conversion of dollars into rubles under the mandated framework for protecting funds from erosion due to inflation. It would also specify the terms and schedule for the Russian deposits into the Nonproliferation Fund, and establish the basic construct for the management of withdrawals from the fund.

4. Russian Federation: in this case, Russia signals during consultations that it might be willing to enter into a debt for nonproliferation debt reduction construct under the right conditions and then negotiates Agreement(s) with creditor(s).

5. Russia Nonproliferation Fund: a Russian legal entity, perhaps modeled after the Polish EcoFund, established to underwrite the debt for nonproliferation program. The Fund would exist as an account in a private Russian financial institution, rather than a commitment against Central Bank resources.

6. Board of Directors: a multinational oversight body comprised of representatives of all contributing creditors and the Russian Federation to set Fund general policy, establish project funding guidelines, and provide final approval of project proposals.

7. Executive Secretariat: in response to the particular challenges of managing a fund around nonproliferation and in a Russian context, a special body to facilitate Board activities by providing support and information about projects, funding, technical viability of projects and financial advice for the Board of Directors. It provides expert review of projects from both a technical and financial perspective.

8. Implementation Team: day-to-day proposal coordination, project contract administration, and verification of completed deliverables would be tasked by the Board under management contract to an international NGO or other contractor. It may be preferable that the contractor be a Russian-led and staffed organization.

9. Project Contractor: Russian Government or Russian private sector teams would serve as prime contractors to bid request for proposals from the Fund and complete the scope of work.

The next section will discuss the specific requirements and conditions for adapting and integrating this model into the Russia context.

IV. Fund Implementation

Key Points

The Russia Nonproliferation Fund should be founded as a Russian charitable not-for-profit fund (NFP) according to Russian *Law on NFPs,* No. 7-FZ, 1996.

The Russian multi-service financial firm of Delta Capital Management, originally established by the U.S. Government, should be considered for the role of the Implementation Team.

Russia operates on a system of informal personal networks and relationships. The need for personal relationships within the Russian Federal Government as well as at the regional level is necessary for successful project implementation.

The isolation of the nuclear, chemical, and biological weapons complexes from the Russian reform process will make the need for proper tracking mechanisms for project monitoring all the more important.

Extensive knowledge of the Russian legal system, financial sector and noncommercial sector area are just as important to the success of the Fund as knowledge of the weapons complexes.

Due to the unstable Russian banking system, Russian banks should be carefully examined prior to their use for funding transactions for the Russia Nonproliferation Fund.

In Russia, giving financial assistance to companies without technical assistance, i.e. management procedures, training, creation of associations and support to the nongovernmental sector, lessens the possibility of a successful project. It is important to include a mechanism that will support the development of project and program management capabilities.

Key Issues

- In the context of the *Russia Nonproliferation Fund*, what are some of the significant challenges?
- What are the essential functions and features of a Russia Nonproliferation Fund?
- What are the legal structure and operating principles most appropriate for the establishment of the Russia Nonproliferation Fund?
- Are there pre-existing organizations within Russia that can help execute many of the necessary functions of the Fund?

- Within the context of a Russia Nonproliferation Fund, what constitutes the minimum set of project selection criteria?

- What are some of the potential projects that could benefit from a Russia Nonproliferation Fund?

Russia Nonproliferation Fund Challenges

The unique challenges of working in Russia place extraordinary demands on any new institution. The Russian environment, combined with the mission of the Fund, demands that the Fund specifically be constructed to take into account the legal, financial, project management and bureaucratic issues that will impede success. As has been well documented, in Russia projects require hands-on attention to ensure progress and accountability. There are layers of bureaucracy and security within the Russian closed cities that make timely implementation difficult. Russia continues to experience difficulty in controlling corruption, both in the public and private sectors. Russia is beginning to reform the legal system, but has yet to make significant progress on the rule of law and the banking system, making transparency and accountability all the more important. Finally, due to the vertical integration of the government ministries, and the absence of horizontal relationships across different ministries, personal relationships with key government officials are essential to any successful program in Russia.

Institution building in the West poses certain challenges; in Russia, it is even a more complex and demanding task. The Russia Nonproliferation Fund, due to its unique mission and the scope and size of projects, must be designed to perform specific functions that address the problems associated with institution building in Russia. The Fund must be independent, objective and transparent. It must operate to the standards of Western accountability, yet perform within the Russian context, both legally and culturally. The Fund must have a strong project implementation component, and expertise in contracting, grant-making to NGOs, and, to a lesser degree, lending to companies. It must have a flexible design, a key feature of any successful organization in Russia. The scope and potential size of the Fund make it necessary to create a structure that addresses these issues.

Functions and Features of a Russia Nonproliferation Fund

For the Fund to be successful in Russia, it must have certain key features. Perhaps an obvious point, but it is essential that the Fund be an independent entity separate from the Russian government. The need for objectivity and independence was outlined in Chapter 3. Russia does not have a fully developed market economy, nor does it possess many of the features of a democratic civil society. Although the Putin administration has been successful at addressing some of the larger issues of corruption and the overreaching influence of the oligarchs, there exists widespread petty bribe-taking and corruption at most levels of the public and private sectors. In terms of an open society with freedom of the press, there has been less recognition by the Putin administration of its importance and central role in a market economy. The Russian private sector has difficulty understanding the concept of *conflict of interest*, which is reflected in their attempts to monopolize sectors of telecommunications, oil, and media. The Fund must be above reproach in regards to its decision-making and operations.

The Fund must possess Russia-specific contracting, experience and expertise. The Fund must have a deep and thorough knowledge of contracting, grant making, lending, project management, the legal structure in Russia, as well as expertise working in the closed and remote areas. Although Russia has made great progress in reform, it still does not have certain features that are basic components of a Western, democratic society, and support for a market economy. The lack of a free media, a clear electoral process, and workable courts system underscore the need for the Russia Nonproliferation Fund to have specific expertise working in the Russian context. Below are issues that will affect the structure and success of the Fund.

- The Russian legal system is complex. Perhaps it is more accurate to state that although there are many laws, they are often contradictory and incomplete in terms of instructions as to how to apply them in different situations.

- Russian accounting procedures differ from American accounting procedures; it is oftentimes necessary for an organization, public or private, to have both an American and a Russian accountant.[4.1,4.2]

- In addition to accounting, the financial system in Russia is unstable; banking reform is urgently needed, and it is not clear that the Russian government will move quickly enough to avoid a second collapse of the banking system.[4.3]

- Russia operates on a system of informal personal networks and relationships. The need for personal relationships within the Russian federal government as well as at the regional level is necessary for successful project implementation. Not only is it important to have a well-developed network within government, it is also necessary to understand how the ministries interact, and what are the political relationships between the government structures.[4.1]

- Regional governments can assist or hinder the progress of projects. Most project work will be conducted in the regions most affected by the nuclear weapons complex. Knowledge of the regions and their political structure is no less important than the structure of the federal government. At the regional level, personal relationships become even more important, as local officials are often the chiefs and have more control than mid-level deputies in ministries.

- The lack of project management expertise in Russia is well known, and it is the reason why so many projects have not been successful. Russia has acknowledged the need for trained professionals in both the public and private sectors. Russia is making progress; many young Russians are receiving Western education and returning to Russia. However, they cannot begin to address the enormous need for competent managers throughout Russia.[4.4]

The Fund must have the ability to bridge commercial and non-commercial sectors, and build public/private partnerships. It is envisaged that the Russia

Nonproliferation Fund will support various projects, some of which are large and focused on traditional approaches to nonproliferation issues, and others that work on issues that focus on the improvement of the infrastructure of closed cities and other restricted areas. Certainly there will be numerous instances when commercial and noncommercial entities will work independently on specific projects approved by the Fund. In the case of smaller projects, it might be appropriate that a NGO commercial entity receive a grant to provide the services necessary. If a project is to perform a specific but very sensitive task, then a governmental entity working alone might be more efficient. However, public/private partnerships help to overcome some of the barriers and realities of working within Russia.

Public-private partnerships can help in the following ways:

- Most Russian nonprofits have limited capacity to perform large projects. By contrast, Russian for-profit companies have greater resources but do not focus on projects that address infrastructure issues, because there is no market for these projects (they are still believed to be the responsibility of the Russian government).[4.5]

- Public/private partnerships help to address the issue of sustainability. Projects that are based on partnerships create buy-in and commitment of the Russian recipients. Projects in Russia may ultimately fail if they do not address the issue of how they will continue to exist once external funding has ended, and they do not lead to systemic change within Russia. The Russian private sector is beginning to recognize the importance of long term investment, and public/private partnerships give additional incentives for this approach.

- Training, economic development, health, and infrastructure development projects have been largely ignored by governmental agencies in Russia, and have received even less attention from the U.S. government. Public/private partnerships encourage the government sector to work on these issues with the NGO and for-profit elements of the private sector.

By structuring the Fund so that it can perform a number of tasks and work with various organizational structures within Russia, it becomes an agent for change, while taking into account the need for flexibility in working in Russia. By encouraging partnerships between local governmental institutions within the Russian weapons complexes and the Russian private sector, the Fund will encourage the growth of the private sector within the closed cities. The Russian private sector is interested in working within the closed cities, but needs some mechanism that will encourage their participation. Public/private partnerships address that need, and provide incentive to the Russian private sector to invest in restricted areas of Russia.

The Fund needs to have institutional capacity and expertise in large scale financial transactions. As stated above, the Fund will need to be able to perform a number of functions, and to have a flexible structure in order to provide both grants to nonprofits and loans or subcontracts to commercial entities. The lack of domestic lending expertise in Russia may point to the need for this to be a key function of the Fund. Due to the size and scope of activities, expertise in funding oversight is another key feature of the Fund. Institutional capacity and expertise in lending and funding are essential in a Russian context, due to the risky Russian investment environment.

In particular, the banking sector in Russia has gone through several reorganizations over the last ten years, culminating in the collapse of the banking system in August 1998. The risk of investment in Russia has, in the past, scared away large institutional investors, and this lack of large investment in Russia has not allowed the financial institutions to develop a lending capability. Indeed, part of the underdevelopment of the finance sector is manifested in how Russian banks are structured. Mikhail Zaitsev, from MFK Bank, stated that the most recent restructuring of Russian banks exposed the following weaknesses:

- Limited responsibility of top managers and owners when a bank collapses
- Absence of clear legal definition of "liability of management"
- Insufficient protection of creditors' interest
- Absence of a legal base regulating commercial restructuring of "problem banks"
- GAAP standards applied inconsistently
- Lack of transparent processes and procedures
- Lack of internal bank infrastructure
- Lack of good training for bank managers
- Bank loans in Russia are lower by a factor of 5 than in developed countries [4.6]
- Operating costs are high, due to a need to invest in infrastructure, e.g. information technology and training
- Limited investment opportunities
- Profit margins have decreased.[4.7]

Although Russian banks are beginning to be critical of their own structure, and are taking on the task of restructuring to improve their value, reform is still the exception. The lack of banking reform has made access to large-scale capital for projects difficult. In the West, construction companies and any number of larger industrial companies have access to capital through the banking sector. In Russia, financing for large scale projects is usually provided internally by the company performing the work.

The Fund should have institutional capacity and expertise in large-scale implementation of projects and an extensive knowledge of oversight and monitoring within the Russian context. In the West, it is a part of any large project to have many financial checks and oversights. There are audits, quarterly reviews, and criteria regarding management structure. This system of oversight and protection of an investment is beginning to be developed by Russian financial groups and investors, but is still not adequate.

There is a growing awareness in Russia that to attract large investments, a proactive approach to transparency and accountability is needed. Unfortunately, little progress has been made in this arena. The large state enterprises, like Gazprom, have been reluctant to change, requiring the Putin administration to intervene and replace management. Privately held companies are beginning to recognize the need for an internal capacity to implement projects and provide oversight and monitoring. For example, Mikhail Khodorkovsky, CEO of Yukos Oil, has begun an extensive restructuring of his company to improve their internal corporate governance policy; they have a proactive approach to restructuring, and view it as essential to remain competitive.[4.8]

However, few organizations within Russia have the capacity for effective large scale implementation, and even fewer have adequate oversight and monitoring capacity. Within large companies, there is not a great deal of expertise internal to companies regarding implementation and oversight. Stanley Fisher of the IMF notes that foreign investment will not come to Russia until the rule of corporate governance (company responsibility) becomes the standard.[4.9]

It is important to note that problems of transparency and accountability also exist at the local level, where most of the nonproliferation projects will be implemented.[4.10] It will also be important to structure the Fund so that it can address the need for institutional capacity and expertise in large-scale implementation at the regional level.

The Fund must be able to operate creatively despite an inconsistent legal environment and unstable financial systems. The challenges of operating within the Russian context have been outlined in detail above, in particular the legal environment and the unstable financial sector. In addition to the functions listed above, which focus on oversight and the general need for Russian expertise and experience, it is important that the Fund have a creative design, and some sort of adaptive flexibility, in order to respond quickly to the changing Russian environment, and provide various options for project implementers.

The inconsistencies and risks of working within Russia demand that the Fund be able to adapt and respond quickly to changes in the Russian environment. It is essential that the Fund be adept at Russian negotiation while staying sufficiently focused on outcomes to move a project forward. The Fund must be equipped to work beyond the bureaucracy, i.e. follow the Russian rules and regulations, but not allow their inconsistent nature to act as a barrier to progress.

Russia Nonproliferation Fund
Structure and Operating Principles

The legal structure of the Russia Nonproliferation Fund should be able to meet the functions and features outlined in the previous section. It is important that the Fund be able to conduct financial transactions with both commercial and governmental entities and that it have the utmost flexibility in this regard, and that it have oversight and monitoring processes that are rigorous and based on Western standards of transparency and accountability.

The Russian legal system, as is well documented, is still being reformed and constructed to meet the needs of the non-commercial sector, and does not offer a great number of options. Under our grant from NTI, we subcontracted with an international law firm to explore legal options for the Fund. The entire study can be found in Appendix III. Their recommendations are summarized below.

Charitable Not-for-Profit Fund

Under the NTI grant, Battelle hired Coudert Brothers, an international law firm with extensive experience in Russia, to investigate possible legal structures for the Russia Nonproliferation Fund that would allow the Fund to operate according to the principles laid out in Chapter 3, and to perform the functions described earlier in this chapter.

It is recommended that the Russia Nonproliferation Fund be established as a Russian Charitable Not-for-Profit Fund (NFP).[4.11] The Federal Law No. 7-FZ, dated January 12, 1996 regulates the incorporation and activities of NFPs, also known as the *Law on NFPs.* This legal structure gives ultimate flexibility, and allows the Fund to receive funding from a variety of sources, including the Russian Federation or a regional government, or a foreign entity such as the Nuclear Threat Initiative. It allows the Fund to pursue any socially useful purpose. According to Coudert Brothers, distribution of funds by a charitable fund is typically conducted by its management or another executive body (i.e. its board or other collegial body formed by its charter). Although the Russian government, state or local agencies, and certain other institutions are not allowed to be founders of a NFP Fund, they can participate in its executive bodies (i.e. the Board).

There are some drawbacks to this form of legal structure. The legal entity of a *fund* has been misused by the Russian private sector to evade taxes, and this has given funds a somewhat negative reputation. In addition, it is unclear as to what extent the Russian Federal government can be represented in the highest levels of management, and what are the legal procedures necessary for the appropriation of RF funds through the budget process. Both of these issues need further study to determine the seriousness of their impact on this form of legal structure. In addition, Coudert Brothers recommends that further legal analysis is needed to investigate the following issues:

- Rights and benefits of foreign NFPs operating in Russia through branches and representative offices

- Comprehensive empirical survey of other NGOs to explore how they are organized, and their advantages and disadvantages

- Investigation of regional laws, especially in regions where projects are anticipated—could be beneficial to register a NFP in a particular region to support a project

- Further detailed study of the tax system and its impact on a charitable NFP Fund.[4.11]

Fund Asset Protection

Chapter 3 described how asset protection is a fundamental challenge of building a Russia Nonproliferation Fund. Asset protection refers to protecting the fiduciary and foreign policy interests of foreign creditors. As stated previously, asset protection can be described around four major elements: the debt agreement, the framework agreement, program assurance, and project assurance. For the purposes of this section, we will focus on program and project assurance. Program assurance refers to achieving objectivity, transparency and accountability as an institution; project assurance refers to the mechanism for achieving efficiency and effectiveness for day-to-day management of projects. In the Russian context, there are some important considerations that need to be explored in order to achieve both program and project assurance.

A process of Program Assurance needs to be used to guarantee the integrity of the Fund. When it comes to implementation, program assurance revolves around the creation and operation of the Board of Directors. This is the fundamental institutional mechanism for achieving objectivity, accountability and transparency in decision-making. These are achieved by two administrative constraints. The first pertains to the structural features of the Board, as discussed in Chapter 3. The Board must be outside of the direct line authority of the Russian Federation, have a balanced representation, and have a rigorous project selection process. The second pertains to the formation of an Executive Secretariat, which is particularly important to a nonproliferation debt swap. An Executive Secretariat, specifically designed to provide leadership that foreign creditors will accept as legitimate, is key to effective stakeholder representation and Fund accountability.

The Board of Directors for the Russia Nonproliferation Fund would likely be comprised of representatives of creditors nations, Russian government officials from the Ministry of Atomic Energy, Ministry of Finance and Ministry of the Economy, as well as other affected Ministries, as well as nonprofit organizations involved in nonproliferation issues, regional representatives, and U.S. government representatives. The Board will perform the following functions:

- Define priorities, approve selection criteria, goals and objectives of the Fund

- Review and approve all projects

- Provide financial and managerial oversight of the Implementation Team

- Approve the Implementation Team’s senior management.

The Executive Secretariat will provide support and information to the Board of Directors about projects, funding, technical viability of projects and financial advice for the Board and the Implementation Team. The Executive Secretariat will answer to and report to the Board of Directors, and provide expert review of projects, from both a technical and financial perspective. It is recommended that the Nuclear Threat Initiative assume the role of Executive Secretariat. NTI possesses the reputation and neutrality that will be of great importance to creditor nations, and to Russia. NTI will facilitate Board activities, and serve as the eyes and ears of the board. They will mediate and coordinate between member stakeholders, as well as provide guidance to and oversight of the Implementation Team. According to the legal analysis conducted by Coudert Brothers, there does not appear to be a conflict of interest that would prevent NTI from serving as the Executive Secretariat if it is also a founder of the Fund.[4.12]]

In support of the Executive Secretariat, a *Technical Consultants Group* and *a Financial Consultants Group* should be formed. This Technical Consultants Group will be comprised of technical experts, nonproliferation-based NGOs, and Russian counterpart institutions. The role of the Technical Consultants Group is to provide input to the Executive Secretariat regarding the technical viability of the projects, and their relevance in addressing nonproliferation issues. The Technical Consultants Group will report its findings to the Executive Secretariat.

The Financial Consultants Group will provide financial guidance to the Executive Secretariat, and therefore the Board. The authors suggest that the Financial Consultants Group include members of the Russian financial community (investment firms, banks, prominent enterprises) as well as foreign financial institutions that operate within Russia. Some possible members of the Group could be the U.S. Russian Investment Fund, Brunswick UBS Warburg, Troika Dialog, Renaissance Capital, Citibank, Hermitage Fund, and MDM Bank. The Financial Consultants Group is not directly responsible for how the Fund disperses funds; rather, their role is to offer advice on the financial structure of projects as well as provide an outreach function to the larger financial community. This group should provide input as to the financial structure of projects, financial viability of the project within the private sector, opinions on managerial costs for a project, and overall advice on the financial structure of the Fund itself.

Project assurance protects assets at the project implementation level, and is the responsibility of the Implementation Team, as outlined in Figure 3.7. Earlier in this chapter, there was a detailed discussion of the challenges of project implementation and oversight in the Russian context. The lack of legal reform, banking reform, program management and implementation capacity, and corruption are all potential barriers to project implementation oversight, and ultimately to the success of specific projects. It will be essential to have a tightly structured Implementation Team to protect not only assets, but also to strengthen the viability of projects.

The Implementation Team will provide day-to-day oversight of contractors. In order to be successful within the Russian context, the Implementation Team will need to perform the following functions:

- Project preparation, consulting advice and assistance in the development of project proposals

- Initial project selection

- Operational management of the Fund, including accounting, management, and staffing

- Managing and hiring technical and legal staff when necessary for specific projects or for the operation of the Fund

- Provide a link to Russian lending institutions

- Provide the implementation and financial oversight of contracts, grants, and loans provided by the Fund

- Project oversight, including consulting, financial and managerial, and gauge progress through monitoring and evaluation

- Provide biannual reports to the Board on projects approved, their progress, and projects to be considered by the Board.

There are basically two ways to structure the Implementation Team so that it possesses the necessary capabilities to oversee the management of projects. First, the Implementation Team could be created as a wholly new entity, and the capability would be built from scratch. There are a number of challenges in taking this approach. The Fund would need to recruit and assemble a core staff with expertise in finance, program and project management, as well as have extensive knowledge of nonproliferation issues in Russia. This is not only expensive and time-consuming, but also would undermine the credibility of the Fund, as it would appear artificial and contrived to Russian partners.

A second approach is to search for an existing Russian entity that would be able to perform the functions of the Implementation Team. This approach would help the Fund to be perceived as a credible organization, is less time consuming, and is less expensive. However, there are few organizations that possess both the capacity and necessary capabilities to serve this role. Some of the best organizations, such as Eurasia Foundation, have a great deal of experience working in managing Russian projects, but they only distribute grants, and have no experience working on large scale projects that are technical in content. Other large organizations, like the European Bank for Reconstruction and Development, have expertise in managing large scale technical projects, but are inflexible in their structure and provide minimal project implementation assistance and oversight. An existing organization is preferable, if a suitable one can be found.

Fortunately, Battelle has identified one organization that possesses capabilities that correspond to the necessary functions of the Russia Nonproliferation Fund: Delta Capital Management. DCM has the capabilities required to address inadequacies in legal protection, financial reform, project management, and bureaucratic regulations endemic to Russia.

Delta Capital Management--Capabilities

Delta Capital Management was established in 1999 to streamline the activities and operations of the U.S. Russia Investment Fund (TUSRIF). TUSRIF was created in 1995 to offer financing and management support to Russian enterprises, Russian-Western joint ventures, and Western firms interested in entering the Russian market. The U.S. Congress, through USAID, appropriated $440mn to carry out this mandate. The establishment of Delta Capital Management has led to additional private sources of funding, and expanded the original financial services that TUSRIF offered.

The structure of Delta Capital Management (DCM) is unique; it has Western standards of transparency and accountability, but works effectively within the Russian context. DCM has the flexibility to work as a bank, a leasing company, a grant making organization, an oversight project implementation company, and an investment company. The authors do not believe that there is another organization in Russia that can offer all of these services, and function with a Western structure within the Russian context.

1. Delta Capital Management has the capability to serve as a lending institution for the commercial sector and as a grant making organization for the noncommercial sector. It is envisaged that projects could be managed by a commercial company, or by a nonprofit organization. The Russia Nonproliferation Fund must be able to operate in both the commercial and noncommercial sectors. DCM, a registered Russian legal entity, has a unique relationship with its founding organization, TUSRIF. TUSRIF has a special nonprofit tax-free status, and is covered by a bilateral treaty between the U.S. and Russia. This special status and relationship between TUSRIF and Delta Capital Management gives it an extraordinary amount of flexibility. For example, this flexibility allows Delta to provide grants to nonprofits, to administer those grants either onshore within Russia or offshore, and allows the Fund to choose from a number of options regarding how to fund projects.

2. Delta Capital Management has the capability to serve as a bank. They possess two commercial banking licenses (including purchase of a banking license held by J.P. Morgan), which allow them to operate legally within the Russian context. The banking licenses are operated by two DCM subsidiaries, Delta Credit and Delta Bank. Delta Credit focuses on personal and mortgage financial services, and Delta Bank works on corporate financial services.

   It is an advantage to have a relationship with an organization that has the legal right to operate as a bank within Russia. Banking licenses, issued by the Central Bank, are rarely granted to foreign entities. Even though Delta Credit and Delta Bank are Russian banks according to Russian law, they have a special partnership with Delta Capital Management, and have rigorous internal procedures regarding lending. In addition, Delta Capital Management’s operations are monitored by TUSRIF, which in turn is monitored by USAID biannually. These layers of oversight and monitoring provide an additional guarantee of transparency and accountability, a prime feature of Delta Capital Management’s subsidiaries.

3. Delta Capital Management has the capability to serve as a flexible and innovative organization. This flexibility and innovation is reflected in Delta Capital’s investment

philosophy, which focuses on flexibility and working within the Russian context. It is rooted in the belief that partnership management and a long-term investment commitment are required to bring Russian companies to their full potential.[4.13, 4.14] They also operate their company on the principle of *partnership management*, which employs strategies that go beyond traditional investment. The commitment to innovation and flexibility is a key feature of Delta Capital, and is a necessary skill when working within the Russian environment.

4. Delta Capital has the capability to achieve maximum transparency, because of its mandate to provide integrated and comprehensive financial services. DCM has two financial service organizations, Delta Credit and Delta Bank, which provide personal and corporate services. There is also Delta Leasing, a Russian entity that leases equipment to companies looking to start operations or expand. DCM also runs a successful small business-lending program, which has a 97% repayment rate ($43mn have been loaned through this program). In addition to these financial services, DCM can provide contracting and grant-making capabilities. All of these services are important to the Russia Nonproliferation Fund, which will require a number of different financial functions. The advantage with Delta Capital Management is that the services are all located within the same organization, which would allow the Fund to strategically partner with one umbrella organization, and not create multiple relationships with many different organizations, thus making transparency and accountability more of a challenge.[4.13]

5. Delta Capital has the capability to manage the implementation of projects; indeed, this is one of their criteria for selection of investment projects. DCM has worked extensively in Russia for the past five years, and is well aware of the need for project management with the majority of Russian projects, either in the commercial or noncommercial sectors. The philosophy of Delta is to be intimately involved in the management structure of organizations where they have an investment. Companies that do not express a willingness to involve Delta Capital in their management affairs usually will not receive funding for projects from Delta.

In addition to the necessary capabilities outlined above, Delta Capital Management possesses some additional unique features:

- The ultimate shareholder of Delta Capital is the U.S. government, since the Congress originally appropriated the funding for the initial Fund. This gives Delta Capital an “implicit guarantee” of stability.

- Delta Capital can work as an executive agent on behalf of a foreign organization, which lessens the administrative burden on the Fund, and provides an easy avenue to disperse funds.

- Delta Capital Management is interested in taking an investment or shareholder position in any company that receives funding from them. This is an additional way for the Fund to leverage other financial resources, and this helps to address the issue of sustainability and success of projects.

- Delta Capital Management has expressed an interest in being a co-financier of the project that meets their investment criteria. This provides another avenue to leverage funds from an outside source, and also adds to the legitimacy of the Russia Nonproliferation Fund.

Russia Nonproliferation Fund Fundamental Project Selection Criteria

The project selection criteria presented in this section are intended not as absolutes but as a starting point for the Fund's Executive Secretariat to develop at some later date. This list, or one similar to it, serves to initially help clarify the goals of the Fund. There are really two groups of criteria: one representing proliferation prevention and related security goals, and the other representing process effectiveness considerations. All need to be considered in the context of the Russian location where the work will be performed, taking into account security and access constraints. Final project selection criteria will be proposed by the Executive Secretariat and approved by the Board of Directors of the Russian Nonproliferation Fund. As a starting point, the authors suggest that projects should:

1. Address specific proliferation concerns, related to such problems as securing and disposing of dangerous or enabling materials, and preventing the loss of technical expertise to rogue states or sub-national groups. In the case of topics not as directly connected to nonproliferation (health, environment, business development, capacity building), projects need to demonstrate partnership with a local entity that is connected to the weapons complex, to ensure that the projects are relevant.

2. Possess a dimension that removes hurdles to downsizing of Russian nuclear, chemical, and biological weapons complexes to a level consistent with international arms control agreements.

3. Demonstrate irreversibility in relation to the production of WMD—the more the better.

4. Utilize contractors with experience and access to the nuclear, biological, and chemical weapons complexes. Some work will undoubtedly be contracted to state enterprises to complete.

5. Whenever possible, rely on contractor partnerships between a state enterprise and a Russian private sector. This will help to encourage the development of a commercial sector with a self interest in helping to sustain a Russian focus on proliferation prevention.

6. Address financial management issues with project staff that are qualified to report in both Russian and Western accounting systems. [4.1]

7. Take into account regional issues, sensitivities and needs by developing projects based on a bottom-up rather than top-down approach. Experience has shown that regional projects that are based on regional needs are often more likely to succeed, as opposed to projects chosen by the Russian Federation. This bottom up approach

has proven especially successful in projects focused on the environment and the economy.

8. Demonstrate cost sharing rather than full reliance on the Fund for financing projects. When there is a joint commitment of funds, a project has a better chance of success.

9. Identify projects that would otherwise not be pursued by the Russian or U.S. governments. In addition, certain projects suggested by Russian officials that fall outside the parameters of U.S. government assistance may still qualify as projects worthy of consideration.

Brief Examples of Potential Projects

Below are some sample projects to give an idea of the types of large-scale projects that might be appropriate for funding through a debt swap. Of course, these are suggestions only, and are not intended to be all encompassing. Rather, they are consistent with key project selection criteria, and are not funded to date by either the U.S. or Russian government.

Materials, Protection, Controls and Accounting: Sustainability Projects

Several organizations have been established within the MPC&A program to provide training, methodological support, and technical assistance at designated sites. These organizations need funding to survive, and the funding must come from either the sites themselves, the Russian government, or the U.S. The Russia Nonproliferation Fund would be an excellent means to transition financial support for these organizations from the U.S. to Russia without requiring immediate full support from MinAtom's annual budget. The organizations requiring some level of financial assistance include the Russian Methodological and Training Center and the Interdepartmental Special Training Center in Obninsk, Russia, and the Siberian Technical Support Center near Novosibirsk.

The current primary procurer of MPC&A equipment in and for Russia is the U.S. government, through program implementation undertaken by laboratory project teams. Both Russian and foreign manufacturers have provided equipment and technical support to date. As Russian enterprises gradually begin to directly choose and procure equipment for their MPC&A needs, they will require a group of vendors and service providers that can offer affordable, high-quality equipment and the accompanying necessary technical expertise. This project would support vendor identification, training, equipment upgrades, certification of equipment, and prototype development activities of promising Russian manufacturers of MPC&A instruments and systems.

A mature and effective program of internal and external inspections detects noncompliance with regulations and provides incentives for nuclear enterprises to place a high priority on nuclear material security. Safeguards usually impede operations and slow production capacity so an effective inspection and enforcement program is essential. This project would fund travel costs and training for inspectors from MinAtom and GAN and support the equipment maintenance and infrastructure necessary for inspections to occur.

Weapons Complex Ecological Remediation

This project would put Russian nuclear weapons production scientists and engineers to work cleaning up Cold War legacy wastes to meet multiple Russian, European, and U.S. goals. The project would support nonproliferation and defense conversion projects with scientific and engineering content, and provide high-quality gainful reemployment of Russian nuclear weapons complex workers. The project not only improves the environment around the closed cities, but also improves the health and safety of the local Russian population. Finally, environmental remediation addresses the issue of creating a better infrastructure for commercial investment in closed cities in Russia.

Plutonium Disposition and Elimination

One project that could be considered under the umbrella of plutonium disposition needs is a facility for fabrication of the lead test assemblies for prototype mixed oxide (MOX) fuel designs useful to the disposition program. This facility could be fabricated as a joint use facility for fabrication of both U.S. and Russian test assembly designs and be located in Russia. This would allow current U.S. investment in development of this facility to be leveraged to benefit both governments. Development of a joint facility also creates a direct means to transfer the fabrication experience of the U.S. MOX contractor to the Russian Federation. This type of technology transfer, i.e. transfer by doing vs. transfer by telling, could effectively eliminate the resistance to adopting proven technology by showing success as opposed to trying to convince the Russians that this is the way to do it. The commercial need for the facility on an accelerated schedule would create a non-government schedule driver for facility completion which would accelerate the Russian schedule for this project, and shorten the time required for the start of plutonium disposition in Russia. Using the lead test assembly fabrication facility would demonstrate the feasibility of this approach for funding and deployment of the full-scale fuel fabrication facility in Russia for plutonium disposition.

Another important contribution debt conversion could make is to contribute to the reduction of the social and institutional hurdles to elimination of weapons-grade plutonium production. The U.S. and the Russian Federation are pursuing cessation of plutonium production at the Mining and Chemical Combine (MCC) and Siberian Chemical Combine (SCC) in Siberia by replacing the existing heat and power capabilities of the ADE reactors with fossil power supplies. Reactor operations provide employment, not only for reactor operators, but also for personnel at the reprocessing facilities, the plutonium processing and storage facilities, the uranium reclamation plants, the waste management and other portions of the infrastructure. Reactor shutdown will have significant labor force impacts which will exacerbate the currently high unemployment at these sites. The larger community will also observe a multiplier effect—as each job is lost at the Combine, the associated closed city will lose 3 to 5 jobs. The tendency of workers and management in plants scheduled for shutdown to resist change is well known, but is particularly a concern when applied to specialized nuclear production skills in a closed city with minimal broader market. Such problems were observed in the U.S., at the largest U.S plutonium production site (Hanford), where a cleanup program lasting fifty years and costing perhaps $90bn was substituted for a materials production mission, but resistance to shutdown was still observed. It would be naive to pursue reactor shutdown without considering the social impacts to the community and the workers. Reactor and production facility decommissioning and decontamination, funded by debt conversion, would serve the dual purpose of providing a visible future for the workers at the sites, and would serve to irreversibly shutdown these facilities.

Counterterrorism Support

There is a need to develop technologies that will create new capabilities along the entire spectrum of activities: interdiction, prevention, crisis management, recovery/restoration and attribution. Russians have considerable expertise in WMD that could be brought to bear on this problem. This project is large in scale, and addresses both the need to develop new technologies, as well as providing appropriate technical jobs for downsized nuclear weapons workers, thus meeting the suggested project selection criteria for the Fund.

Multipurpose Submarine Dismantlement

There are approximately 120 tactical submarines that need to be dismantled and their nuclear fuel safely and securely stored. To date, this project has not met international proliferation threat reduction criteria for funding. This project is relevant to global concerns about Arctic Ocean environmental degradation, as well as addressing a proliferation concern for the United States and for Russia. The cost of dismantling a submarine is several million dollars, including fuel storage and security.

Russian Nuclear Power Plants Security

A 1999 security assessment performed by the Department of Energy identified the physical security at nuclear facilities in Russia as well as other NIS countries as inadequate. The Russian facilities need substantial improvement to meet minimum-security requirements. Security personnel at Russian sites are currently working within the constraints of old equipment and outdated technology provided under the original plant designs. Russian security personnel are concerned about their ability to maintain physical security systems to meet their existing limited physical protection rules, and they feel they cannot meet the more stringent requirements used today in the United States and Europe without outside assistance.

It is estimated that it will cost approximately $67mn to upgrade the security at the Russian nuclear power plants to meet the current security requirements. However, the Russians are not currently performing these needed upgrades and there is no international assistance being provided to Russia to improve security at the nuclear power plants. Using the debt conversion process to fund these needed upgrades would improve the security and reduce vulnerabilities at these nuclear power plants.

European Nuclear Cities Initiative

The European Nuclear Cities Initiative (ENCI) was created for the development of projects with Russian Nuclear Cities weapons scientists and technicians using their expertise to support the needs of western/European research centers, enterprises and organizations. This is an initiative that is still searching for funding. ENCI was created to enhance existing on-going activities for nonproliferation, to enhance European involvement in collaboration with Russia for nonproliferation, to facilitate the commercial activities in the Russian nuclear cities and to propose new approaches and methodologies for their conversion to non-weapons economies. A focus of ENCI is to develop innovative technologies for energy efficiency and environmental monitoring.

V. Path Forward

Key Points

There are three fundamental roles for NTI if it should decide to lead in the implementation of a Russian debt for nonproliferation initiative: 1) developing creditor contributors, 2) founding the Russia Nonproliferation Fund, 3) serving as the Executive Secretariat to the Board of Directors of the Fund.

The fundamental recommendation of this Concept Development Proposal is that NTI should undertake the preparatory work to found the Russia Nonproliferation Fund.

The *New Partnership* between the U.S. and Russia, forged after the September 11th terrorist attacks, provides for a positive backdrop to a debt for nonproliferation swap initiative.

NTI should immediately direct the considerable influence represented by its Board and by its senior operating officers to the task of garnering the additional authorization and appropriation support for S.1803, Title III, the Debt Reduction for Nonproliferation Act of 2001.

The timing is good for NTI overtures to the Department of Treasury to establish a primary point of contact there to seriously explore NTI bilateral debt acquisition opportunities with the United States Government.

NTI should begin similar interactions with other creditor nations to promote the concept, gauge interest, and help establish an internationally recognized role for the Initiative.

NTI should assemble a prospectus on the charitable contribution tri-partite concept and begin contacting appropriate Russian commercial creditors in the U.S. and abroad on a one-on-one basis to gauge interest.

It is imperative that a close working relationship with one or more commercial financial institutions be established by NTI in order to stay abreast of market information and receive help identifying creditors.

The Fund's Executive Secretariat should be led by NTI, and should consist of a Technical Consultants Group, led by Battelle, and a Financial Consultants Group led by a commercial financial institution.

When NTI and Battelle initially began in early CY2001 to consider a concept development proposal in the area of debt for nonproliferation debt swaps, we were jointly focused on finding London Club debt that could be heavily discounted as part of a tri-partite approach, the overlap with bilateral debt swaps was considered small, there was no related legislation working its way through the U.S. Congress, and overall financial opportunities were considered relatively modest as compared to the total of U.S. CTR and other investments to-date. About the time NTI contracted with Battelle to begin work, momentum at home and abroad began to pick up. This really happened as a direct result of a PNNL European Nuclear Cities Initiative (ENCI) Debt-for-Ecology paper (Como, Italy in July 2001) and the positive response to it in this international forum. The Senate Foreign Relations Committee and others on Capitol Hill took greater notice, and we, in-turn, learned from interactions with them and with a few Bush Administration officials what was attractive about the concept (and what was not). We were challenged as part of these interactions, for example, to garner some FRG interest. Then the *New Partnershi*p between the U.S. and Russia was forged after the September 11th terrorist attacks. Even as we learned about the significantly diminished financial motivations in the London Club and Paris Club for further Russian debt reduction, the political motivations seemed to grow. And recently, as the possibility of a sustained soft oil market becomes more worrisome to producers and investors with every passing day, the need for some sort of Russian debt restructuring in the future does not seem so far-fetched. At present, the Debt Reduction for Nonproliferation Senate Bill is pending conference with the House, and the authors have come to understand that NTI can play a significant role in interacting and partnering with the official bilateral sector as well as the commercial sector.

These conditions and our analyses point to several plausible next steps for NTI to consider undertaking. In fact, the concept is at a critical juncture, meaning that NTI can have a real impact on the acceptance and implementation of Russian debt for nonproliferation. Time and funding did not allow for Battelle to provide cost estimates for these next steps, but we would be pleased do so if requested by NTI as a brief shared-cost follow-on to this effort. The authors' recommendations for next steps can be parsed according to three broad categories: 1) generating additional U.S. and western official creditor support, 2) identifying potential commercial/private sector partners, and 3) formally establishing the Russia Nonproliferation Fund.

Generating Additional U.S. and Western Official Creditor Support

The authors recommend that NTI immediately direct the considerable influence represented by its Board and by its senior operating officers to the task of garnering House authorization support for S.1803, Title III, the Debt Reduction for Nonproliferation Act of 2001, during the upcoming conference, and likewise work to support Congressional authorizers in their effort to promote it with appropriators in both houses. While it may not seem so, an element of this effort that is probably just as critical to NTI as passage of the measure itself, is language that allows, or better, directs the establishment of a Russia Nonproliferation Fund as the facility or subordinate entity whereby the proceeds from the swap with the U.S. are directed. It is important that principals at NTI remain generally familiar with the Congressional initiatives and language associated with debt for nonproliferation in order to promote measures that are congruent with its own goals, measures that provide enough direction but enough flexibility to maximize the benefit of the resulting public-private partnership between NTI and the U.S. Government, as well with other official and private creditors.

The timing is good for NTI overtures to the Department of Treasury to establish a primary point of contact there to seriously explore NTI bilateral debt acquisition opportunities with the United States Government. It may be that the USG might see value in partnering with NTI pursuant to provisions set forth in the Credit Reform Act of 1990. NTI should explore the possibility with Treasury of acquiring older (e.g.: WWII era) debt at a discount from its net present value in order to undertake a tri-partite write-off swap with Russia. NTI should also more formally interact with other Bush Administration principals to make them aware of the potential but strong interest of NTI in debt for nonproliferation swaps in order to help establish a leadership role for the Initiative in any of the forms in which the concept may evolve.

NTI should begin similar interactions with other creditor nations, perhaps a little more informally than with the United States, to promote the concept, gauge interest, and help establish an internationally recognized role for the Initiative. Refer to Table 2.2 for the list of other potential government partners. Interactions with the FRG, in particular, should begin immediately, to develop an NTI role in any debt for nonproliferation swap associated with Russian-German settlement of the $6bn GDR debt issue. A strong positive indication from one or more potential foreign partners might actually encourage a positive consensus within the USG for a Russia Nonproliferation Fund.

Finally, NTI should consider either funding Battelle, another subcontractor, or exploring for itself the opportunities for swaps based on Russian regional government debt. The amount of time and funding available for this study did not allow Battelle to explore this to the degree it is warranted.

Identifying Potential Commercial/Private Sector Partners

Even though Battelle analysis of the Russian external debt suggests that Eurobonds are presently a good value for investors, and thus not likely to be available for charitable receipt or discounted purchase by NTI, stronger ties need to be established between NTI and specific segments of the private financial community. If the price of oil were to drop further, or even stay below $20/bl for an extended period of time, the popularity, thus value, on the secondary market of Eurobonds will decline. This possibility, combined with important other factors could conceivably provide NTI with the ability to establish a consortium of private corporate contributors to a Russia Nonproliferation Fund. Perhaps the financial world would warm to a solicitation of charitable contributions where the difference between the tax advantage gained and the assets lost would be acceptable. This acceptance would be based on the fact that it was the financial community and its people who suffered so grievously and disproportionately from the September 11th attacks. This community probably can perceive the impact of a WMD attack with more urgency than other segments of U.S. society. And it is this same financial community who arguably will benefit the most and the soonest from a stable Russian economy. Perhaps there are members of the private financial community who would be willing to forgo some near-term profits to cover the difference between a tax write-off and asset value. This, combined with the secrecy surrounding private ownership of the Eurobonds, means that NTI should assemble a prospectus on the charitable contribution tri-partite concept and begin contacting appropriate Russian commercial creditors in the U.S. on a one-on-one basis to gauge interest.

Further work also needs to be undertaken to understand NTI charitable contribution opportunities from private creditors abroad. The authors recommend that the same sort of one-on-one contact with these creditors then be initiated to gauge their interest. The first step in this process is to develop a thorough understanding of foreign charitable contribution laws and practice, and then modify the prospectus assembled for U.S. creditors so that it pertains to a particular foreign private creditor.

Even though Battelle has provided a partial listing of both U.S. and foreign private creditors in Table 2.1, the secondary market for Russian Eurobonds is very fluid. If NTI decides to undertake Battelle's recommendations in this sector, it is imperative that a close working relationship with one or more commercial financial institutions be established so that NTI can stay abreast of market information and receive help identifying creditors. For the purposes of this study, George Russell as CEO of Frank Russell Company in Tacoma, Washington asked his staff to assist Battelle at no cost to NTI or us. Mr. Russell recently retired from this position, and now heads the Russell Family Foundation – a Foundation that will undoubtedly continue to pursue solutions to helping Russia transition to a market-based economy, to reduction of the possibility of proliferation worldwide, and to other problems affecting global security. His help and that of his staff was invaluable to Battelle and NTI for this initial effort, but we believe more formal relationships with financial advisors will be necessary if NTI chooses to pursue private sector debt swaps further.

Formally Establishing the Russia Nonproliferation Fund

The basis for the Battelle recommendations to NTI to influence the U.S. Congress as it considers the new Russian debt swap legislation, and to begin closer and more direct interactions with both official and private creditors is that the authors believe that NTI is in an excellent position to be the recognized lead founder of the Russia Nonproliferation Fund. NTI can and should also work to ultimately be seen as the informal, if not formal, executive agent for the Fund, and thus the coordinated public-private partnership the Fund could represent. ***The fundamental recommendation of the Battelle Concept Development Proposal is that NTI should undertake the preparatory work to found the Russia Nonproliferation Fund.*** The preparatory phase should be conducted so that it has a definitive end-point at which the NTI Board would have the information it needs to make a go/no-go decision about founding the Fund.

Battelle has provided detailed information about a construct for the Fund as a major component of our work for NTI. However, as more parties become involved, elements of our initial suggestions will most likely need to evolve to meet the needs of the other stakeholders, not the least of which will be the Russia Federation. However, a good network has already been established and the authors recommend that the next step for NTI is the formation of the Advisory Panel (Figure 3.7 and associated narrative). Members should include representatives from Coudert Brothers, Institute for Private Sector and Socio-Economic Analysis, Troika Dialogue, Battelle, and others familiar with swap funds and Russian proliferation prevention issues. A recommended initial activity is a 3-day workshop in Washington to critique Battelle's analyses and recommendations, followed by completion of the necessary preparatory activities for NTI Board approval of the action to found the Russia Nonproliferation Fund.

In summary, there are three fundamental roles for NTI if it should decide to lead in the implementation of a Russian debt for nonproliferation initiative:

1. Developing creditor contributors

2. Founding the Fund

3. Serving as the Executive Secretariat to the Board of Directors of the Fund.

The purpose of the Executive Secretariat is described in the previous two chapters. This is necessitated by the complexity and potential breadth of the concept. Battelle believes that the Secretariat should be supported by two subordinate groups: a Technical Consultants Group and a Financial Consultants Group as arms to anticipate and resolve technical issues needed by the Board. We think that the Implementation team will have enough to do in assuring that projects selected by the Board on the advise of the Executive Secretariat are initiated and completed, and the contractors compensated, that another element needs to be created to provide direct technical support to the Board and directly facilitate Board activities. Because Battelle has invested so much effort in the debt for nonproliferation concept since its inception by us, and because of our extensive experience in global security and Russian nonproliferation work, we would hope to play a primary role and serve NTI as the lead for the Technical Consultants Group.

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