Sovereign Debt Restructuring: Issues Raised by Recent Experience

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Overview

I. Understanding the scale of the debt challenge (debt transparency)
II. Understanding the envelope for repayment
III. Complications from shifts in types of financing used by countries
IV. Creditor Coordination (managing hold-outs)

I. Understanding the Scale of the Debt Challenge

- Transparency is critical to promote sustainable lending and avoid debt distress, and it is equally important when there is a restructuring:
  - The calibration of a solution will be wrong if liabilities are under-estimated
- Recent cases have showcased the difficulties in this area:
  - Where state enterprises are involved: (i) non-disclosure clauses from lenders; and (ii) internal governance/oversight issues (MoF or DMO may lack remit to request data)
  - Disguised debts (e.g. borrowing reported by resource companies as revenues/forward sales)
  - Arrears to suppliers (often involving difficult verifications)
  - Other debt-like obligations (PPPs, swaps, "barter" arrangements)
- The need to improve debt transparency has been prominent in the policy agenda of late:
  - IIF initiative (successor to a Credit Suisse-led initiative); G-20 work; and increased focus by IMF and WB
- How this is being handled: Gear up debt management TA, and in the near-term, take the necessary time to get the info (it can take months to get an adequate measure of the scale of public liabilities)

II. Understanding the Envelope for Repayment

- The IMF's medium-term macro-fiscal forecasts are used to establish an envelope:
  - ➢ In programs explicit limits on debt and gross financing needs can be set (e.g. in Ukraine program)
- Issues:
  - ➢ What is feasible for a country in terms of fiscal adjustment/preservation of social protection?
  - ➢ How to value wealth related to natural resources? They do not always guarantee adequate repayment capacity down the road (price volatility, recovery rates, technical change may affect viability)
- How this is being handled:
  - ➢ More careful attention to setting floors on social spending in IMF programs
  - ➢ Value recovery instruments of some form deployed by countries and their advisors to address resource-related uncertainty (design/standardization an important lingering issue)

III. Complications Created by Shifts in Types of Financing Used by Countries

- Collateral (has shown up in all the recent resource-related cases)
  - The problem is not trade finance collateral. Rather: collateral on future commodity revenues; or on key income-generating assets; or "excessive" escrow accounts
  - The issue is that it can impose senior difficult-to-restructure debt on the situation
  - How handled: Countries need the right legal advice in this circumstance (approach depends on the quality of the collateral—generally collateral inside the country is harder to enforce)
- Domestic currency debt
  - Legally easier to handle (can retrofit features into debt contracts, like aggregated CACs)
  - But economically problems can arise: Behind the banks and pension funds are deposit holders and pensioners, and writing them down can have deep social and economic impacts
  - How handled: Careful economic analysis of the situation is needed of who can bear the cost, at what magnitude, and are there alternatives with less complexities and lower costs than restructuring (e.g. taxes?)

IV. Creditor Coordination (Managing Hold-Outs)

- **Official bilateral debt**. Problem: coordination mechanism is built around the Paris Club, and non-Paris Club creditors are becoming increasingly important lenders

- **Three options to handle this** (no examples of success yet in current open cases):
  - **Leverage the existing Paris Club process**, by trying to get other creditors to participate on an ad hoc basis. Advantage: dovetails nicely with IMF policies, giving leverage over minority hold-outs. Disadvantage: where other creditors are large relative to the Paris Club, may be difficult to arrange
  - **Rely on the largest non-Paris Club creditor to coordinate other creditors**. Advantage: A dominant creditor may prefer this. Disadvantage: Does not necessarily align with IMF policies, meaning potential problems with hold outs (unless dominant creditor has some leverage with them), and high upfront learning costs (may need time to reach appropriate resolution)
  - **Rely on legal and financial advisors to coordinate official creditors**. If all else fails. Disadvantage: Expensive (high fees); some leverage may be lost, leading to hold outs or deals that are “too little”

IV. Creditor Coordination (Managing Hold-Outs) (cont’d)

- **Commercial debt**: Problem: More complex creditor structure (bonds, commodity-traders, banks), with different degrees of protection (old vs new legal features in bonds; some have collateral; etc)
- **What are countries doing?** Hire legal and financial advisors, and let them identify a strategy to achieve the aims of the restructuring while minimizing hold outs. Problems with hold outs more likely, however
- **Options to further smooth debt resolution**:

  - **Sovereign Debt Restructuring Mechanism (SDRM)?** Promoted by the Fund, 16 years ago, but there was no support in the international community at that time—including in EMs—and we detect no support for it now
  - **Further strengthen the contractual approach.** Encourage countries to proactively address the stock problem of sovereign bonds with older contractual features. Further enhance contractual features; e.g. current initiative in the Caribbean to explore ways to get higher uptake of natural disaster clauses (extendible features)
  - **Strengthen IMF policies supporting debtor-creditor engagement.** Extend formal policy to pre-default cases? Check that key policy aims/principles remain correctly articulated (e.g. good faith). Another issue is the need for a clearer perimeter for official vs debt (as this underpins seniority structure)

Thank you!

Background: Evolution of Creditor Structure

Private sector:

- Bonds
- Banks from diverse jurisdictions
- Commodity traders

➢ More difficult to avoid holdouts (e.g. aggregated CACs do not extend)

Official sector:

- Non-Paris Club creditors
- Plurilaterals (senior?)

➢ PC CoT no longer effective; in any event IMF policies no longer indirectly support where PC is a minority

LIDCs: Change in Creditor Composition 2007 - 2016
(percent of GDP)