

POLICY BRIEF

The Preferred Creditor Status (PCS) Glut

The search for loss absorption capacity in Africa

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Introduction

Situations of countries with excessive debt burdens, notably in Africa, have been well documented.

While there are many policy ideas to reduce vulnerability to an unsustainable debt burden (increase government revenues, lower debt service via concessional funding, issue contingent debt with adjustable payments...), it is also clear that some situations require nothing less than a straightforward reduction in debt.

Sovereign debt reduction processes have proven frustratingly arduous and slow — even though, on balance, they have achieved their objectives. As we have written elsewhere¹, they have been as successful as the international context permitted.

The reasons why such processes are difficult have been rehashed several times: new actors (China notably), suspicion that others may fare better in the restructuring and lesser agency, from systemically important countries, in multilateralism.

But another way to explain why debt renegotiations have been complicated, especially in Africa, is that debt relief needs are high while loss absorption capacity is low.

Loss absorption capacity is low because some key creditors are reluctant to contribute financially to the resolution of a debt problem due to the potential detrimental impact on their business model — that is, the potential increase in their funding costs.

This Policy Paper broaches the subject of loss absorption capacity, in Africa notably, and the fact it has become sub-optimally low because of the expanding role played by the Multilateral Development Banks, whose contributions to development are critical and which have become important features of the international financial architecture. This is at the heart of the tension between two worthwhile policy objectives: allowing countries with unsustainable debt burdens to get (conditional) relief and protecting the franchise of international development institutions. This paper argues that there are pragmatic solutions to address this tension.

Why is loss absorption low?

Loss absorption capacity is exactly what is needed to meet the debt alleviation needs of over-indebted countries. Yet, this is an extremely complicated matter, where well-meaning sentiments clash with reality.

Indeed, as commercial financial flows to developing countries have slowed down, Multilateral Development Banks (MDBs) have stepped in. This has been very positive for countries that need to finance their development at affordable conditions.

Multilateral institutions such as the World Bank, or the African Development Bank to name a few, have the following characteristics:

¹ Lazard Policy Brief: The 2020-2025 Sovereign Debt Crisis — What have we learnt and what lies ahead? (January 2025)

- they have a development charter, leading them to extend loans at below market conditions to low-rated governments;
- they have government shareholders (which are also, in many cases, their borrowers);
- they are not regulated and depend critically on their credit rating to get access to cheap finance and, in turn, lend at affordable conditions to their members.

To get very high credit ratings, they must:

- be highly capitalized (much more so than commercial banks),
- have an extremely large amount of high-quality liquid assets (as they don't have a central bank as a lender of last resort),
- enjoy the support of their high-income country shareholders (when they are fortunate to have any)
- and, importantly, **show a record of credit losses much lower than the “objective” credit quality of their exposure would suggest.**

This latter feature demonstrably comes from their Preferred Creditor Status (PCS).

These institutions have stepped up lending and also offer guarantees (based on their very high credit rating) to help governments keep market access, though on crutches.

The latest World Bank International Debt Report² shows a large increase in net multilateral debt flows to IDA-eligible countries from an average of US\$14bn annually over 2013-2019 to US\$32bn since 2020. This is in stark contrast with private and bilateral flows which have dried up since Covid. They have played a critical countercyclical role.

The problem is that this has led to a partial substitution of allegedly “sheltered” claims for bail-inable debt. Commercial debt is bail-inable in that it is loss absorptive in case of government default, whereas MDB's claims are protected from incurring a loss, insofar as these organizations enjoy preferred creditor status.

As such, this would not be a problem if PCS was viewed, realistically, as a relative concept, itself dependent on the existence of equally favored competing claims and limited debt repayment capacity. In other words, if a government really cannot repay its debt and has mainly preferred creditors banging on the door, something has to give. But **PCS is too often presented as an absolute concept:** the idea being that an MDB's claims are immune to any losses.

This issue has many ramifications because it concerns not only loans but also guarantees to commercial lenders extended by these institutions. Indeed, in case of a default, guaranteed commercial lenders turn to the MDB that has offered the insurance or the “first loss” (a misnomer as it happens). This MDB then becomes, by virtue of subrogation, the creditor of the country in default. The MDB may choose to offer relief to the country by agreeing to favorable repayment conditions, as was the case in Ghana where the World Bank agreed to concessional repayment terms for the US\$400m it had to pay to bondholders under its guaranty. However, the negotiation becomes much more difficult if the MDB demands to be repaid immediately, on the basis of its PCS. When a defaulted obligation has been guaranteed by a PCS entitled institution, the

² International Debt Report 2024. The World Bank

obligation of the country debtor is transformed from an obligation to a commercial creditor that would otherwise be subject to restructuring to the “non-restructurable” bucket.

Overall, what that means is that while the probability of default by the government has not changed, the loss severity for the unsecured or unprivileged creditor has increased in proportion to the increase in the debt that cannot be restructured. **Not only has the claim shifted, but it has gained in seniority. This has had the unintended effect of reducing loss absorption capacity at the time it is most needed.**

Why is this a significant problem?

The IMF staff has established surreptitiously, in the box of a long paper³, a hierarchy among international lending institutions from the perspective of their standing in the repayment waterfall. In a nutshell, the IMF only considers as “sheltered” (meaning subject to their “non-tolerance of arrears policy”) those MDBs whose members include more than half of the Fund members, or whose members account for more than half of the Fund’s total voting pool) and MDBs identified as being outside the scope of debt restructuring by a “representative creditor committee” — e.g. the European Investment Bank.

It is not our role to opine on who does or does not have a legitimate claim to PCS status.

There are many variations between those that (i) have global or regional membership, (ii) have exclusively or predominantly a development agenda, (iii) have access to cheap or not particularly cheap funding, (iv) have solely or mainly government shareholders, (v) distribute or do not distribute dividends, (vi) lend at commercial or below commercial conditions etc. The IMF staff has distinguished between MDBs and institutions that look like MDBs but are viewed as plurilaterals and expected to make concessions as part of debt negotiations (for example Afreximbank in Ghana).

What is clear is that there are more international institutions claiming PCS than have been identified by the IMF as being entitled to it. And even those that are on the IMF’s list will be in competition with each other, in the face of a limited repayment capacity.

Overall, the international community is faced with a dilemma: either shelter all the institutions claiming to be entitled to PCS at the risk of making it impossible to deliver debt relief (or imposing exceptionally high losses on commercial creditors, possibly leading to litigation rather than a deal); or exposing these institutions to the risk of rating downgrades, higher funding costs and, in the end, raising the cost of capital in Africa.

Both risks are highly problematic. Not delivering adequate debt relief is condemning countries to years of financial struggle; but undermining the credit strength and funding capacity of valuable institutions with a socially useful policy mandate is self-defeating.

Note that the problem is further complicated by the fact that some MDBs reinsured their exposure in the reinsurance market. This, in itself, is highly positive in that it spreads the risk of potential losses and therefore can expand system-wide loss absorption. But this is done at a

³ IMF Guidance note on the Financing Assurances and Sovereign Arrears Policies and the Fund’s role in Debt Restructurings (November 2024)

price that inevitably factors in a PCS halo, otherwise the economics would not work. A repricing of such PCS halo effect may have severe implications for the cost of capital in Africa.

What can be done?

It appears that the growing importance of MDB financing would be a mixed blessing if MDBs were to be totally immune to any credit risk. This would mean an erosion in loss absorption capacity at a very unpropitious time, and an increasingly unreasonable level of loss given default for the residual unprotected commercial lenders.

Beyond the debate around which institutions should enjoy or not a PCS, **a good part of the solution in our view lies on how MDBs can play a role in restoring a country's debt sustainability without losing what makes them different in terms of actual loss experience.**

Indeed, as mentioned above, these institutions show a clear difference between their loss experience and the expected losses of their loan book based on the credit rating of each of their loans. Put differently, a purely commercial lender, with the same portfolio, would very likely incur much higher credit losses. This suggests they in fact enjoy a special status.

That this special creditor status would mean full credit risk immunity cannot reasonably be the hurdle requested to give them a very high rating. Indeed, if they never made any losses, all of them (especially those that are in the BBB-BB range) should rather be upgraded.

Being “part of the solution”, even in pure NPV terms need not mean the same thing for global MDBs supported by high-income and committed shareholders, and regional MDBs supported by weaker though no less committed shareholders. In one case, balance sheet concessions might be compensated by prompt and effective recapitalizations, validating the franchise value of these institutions. This may justify, on a case-by-case basis, that “contributions” by those regional MDBs with a strong policy mandate should be better aligned with their inevitably lower recapitalisation potential.

It follows that **(i) PCS must be viewed realistically in *relative* rather than *absolute* terms; (ii) enjoying a PCS cannot mean full immunity to occasional creditor losses in a restructuring; it means a possible contribution to the resolution of the country's debt problem such that actual losses incurred are much lower than the theoretical risk of lending to financially weak countries; (iii) MDBs, contrary to commercial entities, have the time on their side, committed shareholders behind them and may absorb moderate actuarial (NPV) losses; (iv) the contribution of regional MDBs may have to be aligned with their lower recap potential, to the extent they have an indisputable development agenda.**

Conclusion

Overindebted developing countries, when their debt is judged irremediably unsustainable, must be relieved as much as possible. This means that there must be, on the other side, some loss absorption capacity.

The expansion of MDBs' balance sheets in recent years, and the proliferation of guarantees from super senior institutions, has been a mixed blessing in that it has led to a PCS glut — hell paved with good intentions.

At the same time, MDBs are socially useful development partners lending at reliable and affordable conditions — and/or often addressing a market failure such as trade finance. If they did not exist, they would have to be invented. As such they need to be protected, and their usually very high credit ratings upheld.

A pragmatic solution can be found, even allowing for some constructive ambiguity. The IMF-sponsored Global Sovereign Debt Roundtable could potentially make a decisive contribution.

Contact Information

Lazard's Sovereign Advisory Group is committed to serving its clients: governments and public institutions looking for solutions to their complex financial problems. The sheer scope and importance of these matters also compel us to share our decades of experience for the broad public interest.

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