POLICY BRIEF

HOW TO MAKE SOVEREIGN DEBT RESTRUCTURINGS MORE EFFECTIVE

Hold Warring Parties to a Better Standard of "Comparability"

May 2022

Abstract

This Policy Brief argues that more precise implementation guidelines should be provided on the Common Framework to increase efficiency and accelerate sovereign debt restructuring processes, in particular vis-à-vis the private sector. The required clarifications mainly relate to the definition of the "comparability of treatment", whose definition under the Common Framework remains vague, hence likely contributing to protracted processes.

Executive Summary

Public debt in many countries has surged in the recent years, often to historical highs. Situations of debt distress have proliferated in many developing or emerging countries, two decades after the HIPC initiative.

Yet, the tools to handle those debt crises are not effective enough – as Lazard mentioned back in September 2020 in the Policy Brief "Government Debt in Rough Waters"[1]. In this context, the Common Framework[2] has not fulfilled all its promises so far. With a large variety of creditors, it seems impossible to get an expeditious process, sufficient debt relief and equity amongst creditors. As a result, debt restructuring processes stall, and many countries view this as a deterrent to request debt treatment, often merely postponing inevitable outcomes.

Given the increased heterogeneity of sovereign creditors, the issue of comparability of treatment has risen to the fore. In theory, comparability of treatment means that all creditors should be treated similarly, and that no creditor should benefit from a more favorable treatment than the other ones. The problem is that the definition of what it practically means and implies has remained elusive and mostly judgmental over the years, resulting in a fundamental ambiguity, which has not yet proven to be constructive. This is all the more problematic in the context of the Common Framework which is a zero-sum game for creditors: a lower effort delivered by one class of creditors de facto means a higher burden for the others.

A legitimate policy debate centers on the respective merits of discretion, allowing flexibility, and rules, which increase predictability and transparency.

Based on our involvement on the side of debtor countries in most of the complex sovereign debt restructurings, we have come to the view that the age of constructive ambiguity has evolved. To enable expeditious debt restructurings amongst a wide range of creditors, some simple, precise, transparent and equitable guidelines must be adopted.

Increased clarity and transparency in the definition of Comparability of Treatment would allow to handle parallel and therefore more expeditious negotiations with different classes of creditors instead of the current sequential approach, where the official sector is de facto *the price maker and the private sector the reluctant price taker. Clear guidelines could incentivize creditors to come forward early on to deliver their restructuring effort, without worrying of being dragged again into a second round of restructuring.*

This Policy Paper supports the case for a rather simple measurement of respective creditors' efforts, which would also reduce uncertainty and be conducive to more expeditious processes. Such clarity would essentially relate to how creditors' effort is measured, namely how to calculate the new debt's value-to-old debt's value ratio – a very complex issue.

The suggested guidelines introduced in this paper focus on Low-Income Countries' public debt restructurings because this is the current perimeter of the Common Framework. Should it be extended to Market Access Countries, these guidelines would need to be adapted to the different analytical framework used by the IMF[3].

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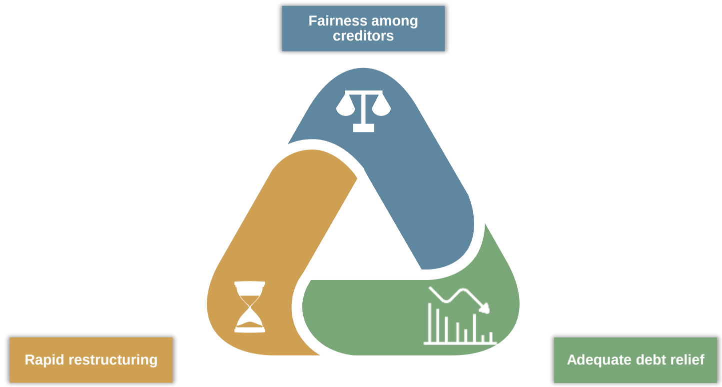
[1] "Government Debt in Rough Waters – A Navigation Guide", Lazard, September 2020.
[2] *In extenso* "The Common Framework for debt treatment beyond the DSSI", an initiative endorsed by the G20, together with the Paris Club, in November 2020 to support, in a structural manner, Low Income Countries with unsustainable debt.
[3] In particular, the IMF DSA Framework does not necessarily imply a zero-sum game for MAC countries as it currently does for LIC countries and the Common Framework.

Another triangle of inconsistencies

With the explosion of public debts following an unprecedented series of shocks (Great Financial Crisis, European debt crisis, COVID…), sovereign debt restructurings have become again a major public policy issue.



Yet, it appears that the international community remains defeated by what looks like an(other) inconsistent triangle: it seems indeed practically impossible to obtain, at the same time, an expeditious process, adequate debt relief and inter-creditor equity, i.e. a satisfactory implementation of the comparability of treatment.

True, we have recently seen reasonably rapidly executed and well accepted sovereign debt restructuring in Argentina and Ecuador, raising hopes on a potential route to meet all three objectives. But both cases involved one category of creditors only, namely bonded debt. Aside from those episodes, other cases involving a wider and more heterogenous set of creditors, in which comparability of treatment is at stake, took however – and are still taking – much longer. This is the case of Zambia, Ethiopia and Chad, all candidates under the Common Framework.

Yet putting in place an expeditious process is critically important: the reason is that a debt restructuring is a heavy and politically charged process keeping a country vulnerable and requiring the full commitment and mobilization of the authorities. While negotiations go on, some economic policy choices can be subordinated to them, and no new funding of the economy is possible. No finance minister will engage into such a process if there is a risk of two perhaps three years of protracted discussions (unless of course there is no money left to pay any debt).

"[…] a debt restructuring is a heavy and politically charged process keeping a country vulnerable"

Obviously, it would seem odd to relax the debt relief constraint: this is the reason of the whole exercise. That said, it should be borne in mind that defining debt sustainability (or the necessary debt relief) is more art than science, even within the IMF/WB Debt Sustainability Framework. The treatment of uncertainty, in particular, is very difficult to handle in an environment where there are essentially no financial instruments to protect countries against this type of risk. Despite its shortcomings, the IMF/World Bank Debt Sustainability Analyses play well their role in anchoring the overall efforts that need to be made by the creditors to put the country back on its feet. We will not delve in this Policy Brief into the question of whether the debt relief quantum determined by the IMF to restore debt sustainability is adequate and credible.

We are left with the issue of the comparability of treatment amongst creditors. It is a sticking point. Can it be made simple, straightforward and as little controversial as possible to enhance the chance of expediting the process?

Comparability of treatment: is ambiguity constructive?

Comparability of treatment is an ambiguous yet central concept.

All debt restructurings, across different classes of creditors, involve a comparison of the efforts made by each class of participating creditors to the grand outcome of restoring debt sustainability. In order to be operational, the method for comparing efforts needs to be agreed upon by all classes of creditors. This requires, at a minimum, that it is simple and transparent.

There is however no clear definition of comparability of treatment. Yet, the concept of comparability of treatment has been enshrined over the years by the Paris Club in the form of a specific clause in their debt treatment agreements, whereby the debtor would commit not to grant more favorable treatment to other creditors, similarly to a Most-Favored-Nation clause[4].

For the purpose of assessing compliance with this clause, the Paris Club had determined a set of criteria including the net present value of claims post treatment, their average maturity, as well as how the treatment contributes to filling the financing gap during the consolidation period[5].

That said, the Paris Club made it clear that these criteria should be applied with flexibility; the same was true with respect to the discount factors to be used to calculate the present value[6]. Discretionary assessment was explicitly encouraged.

In contrast, in the context of the HIPC initiative, ensuring similar treatment for all creditors was easier. A Common Reduction Factor was applied uniformly to all creditors, regardless of their nature. Together with clear guidelines for the use of an appropriate discount factor (one CIRR[7] per currency) and the existence of a reference date for present value calculation (set at Decision Point), this made it easier to claim that comparability was achieved.

A less fragmented universe of creditors at the time, with the traditional triptych IFIs – London Club – Paris Club, combined with the predominant weight of the latter, also made it easier to create traction. In that context, the largest creditors had a clear incentive – and adequate pressure – to make the first move in providing the necessary debt relief effort, championing the initiative within the group of creditors and setting the tone for comparability of treatment.

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[4] The Paris Club doctrine insists that there is no "Reverse Comparability of Treatment", meaning that debtor can always seek more generous terms from other creditors

[5] The consolidation period, usually corresponding to an IMF program, refers to the period during which debt service maturities are being targeted for rescheduling, with a view to closing the identified financing gap.

[6] The Paris Club approach is predicated on the use of an "Appropriate Market Rate" by its members to determine the terms of a debt rescheduling or to compute NPVs. But no equivalent approach was defined for other creditors.

[7] Commercial Interest Reference Rate, as published by the OECD on the 15th of each month.

“Comparability of Treatment is an ambiguous yet critical concept. […] Discretionary assessment was […] encouraged”

After HIPC, the issue of comparability of treatment was kept behind the scenes for a while. More recently however, it resurrected with the Common Framework initiative.

Yet, the G20 communique[8] did not provide much information in relation to it, aside from mentioning the same three criteria used by the Paris Club to assess comparability of treatment. With this sole reference, observers concluded that the comparability of treatment within the Common Framework would rely on Paris Club’s historical assessment rules and process.

This is not necessarily true.

Instead, we understand that the Official Creditor Committee, formed on an *ad hoc* basis for each country case, will be the body setting the rules and assessing whether private sector involvement meets the comparability of treatment principle[9]. With non-Paris Club creditors now being over-represented in most cases, cards are redistributed, and no details were yet unveiled, let alone agreed, to substantiate the definition of the comparability of treatment in the context of the Common Framework.

Lazard experience in dealing with complex sovereign debt restructuring situations, and current involvement in two out of the three ongoing Common Framework processes, strongly suggests that the uncertainty surrounding the definition, perimeter, and application of the comparability of treatment within the Common Framework, is detrimental to the process.

“Uncertainty surrounding […] the comparability of treatment […] is now detrimental”

This may discourage both the public and the private sectors to participate to the required treatment, in a typically non-cooperative game. Public creditors may fear that the private sector will not participate once it has made its own concession. And the private sector, playing second to the public sector, may not feel compelled by rules which are not adapted, in its perspective, to its own constraints.

Also, the absence of clarity regarding the sharing of the restructuring effort amongst creditors makes it impossible for private creditors to expedite the process in anticipating the restructuring of their claims as we had seen in several HIPC cases (e.g., Ivory Coast 2009). Bondholders in particular, often prompt to organize themselves early on, are condemned to wait until an Official Creditor Committee is formed. And other commercial creditors, project financers for instance, are under the obligation to stop disbursing under ongoing projects until more clarity is given regarding the treatment of their claims, especially the undisbursed portion. This altogether creates a wait-and-see attitude from all parties that is not conducive to a speedy resolution process.

[8] “Extraordinary G20 Finance Ministers and Central Bank Governors’ Meeting November 13, 2020”

[9] We infer this from interpreting the G20 official communique and discussing with stakeholders. However, the communique does not specifically mention who will be tasked to determine whether comparability of treatment is fulfilled or not. This is yet another source of uncertainty.

Finally, this level of uncertainty may disincentivize candidate countries to request debt treatment under the Common Framework, by fear of venturing into unknown territory. Rating agencies' promptness to downgrade countries opting for the Common Framework is eloquent in that aspect.

"[…] No details were yet unveiled, let alone agreed, to substantiate the definition of the comparability of treatment"

Why clarifying the definition of comparability of treatment will enhance the likelihood of success of the Common Framework?

In the Common Framework, the IMF is the anchor of the process. It is called upon to determine and present to the official creditors the quantum of relief that the debt treatment needs to deliver.

This quantum of relief can be of two natures:

i. a "*financing envelope*" representing the debt service reduction needed during the consolidation period[10]; and/or

ii. debt sustainability target ratios, in present value at 5% (as per the IMF LIC DSA framework) to be reached, usually by the end of the IMF program or shortly after.

Once the IMF has set the targets, this becomes a zero-sum game amongst creditors. Indeed, to come up with the financing envelope, the IMF needs to set and communicate on specific liquidity ratio targets for each year of the consolidation period. Together with a potential sustainability target in NPV, this entirely and exclusively determines the overall NPV reduction (calculated at 5% discount factor) that a country needs to restore debt sustainability as per program parameters. The overall effort is precisely defined.

"The Common Framework is a zero-sum game amongst creditors"

The comparability of treatment principle then determines how the effort should be allocated between the various creditors or groups of creditors. It is no longer a unilateral commitment by the debtor to seek from its private creditors a debt treatment "at least as favorable" as the one granted by official creditors. Rather it must now reflect a shared vision of what a fair allocation of the burden between creditors is.

The success and timely implementation of debt restructuring processes under the Common Framework therefore partly rely on the ability to provide for a more precise, transparent and consensual definition of the comparability of treatment. Simplicity and unambiguity have their merits here.

Last, absent further simplifications, the international financial community will not be in a position to support an extension of the Common Framework[11] to market access countries where large and complex sovereign debt restructuring episodes are likely to emerge.

"Simplicity has its merits"

[10] The "financing envelope" is a concept receiving a new light in the context of the Common Framework. It represents the residual financing gap produced by the macro-fiscal framework underpinning the IMF program, after application of IFIs' and other donor's contributions. It is the total targeted debt service reduction during the consolidation period.
[11] Currently the Common Framework only applies to countries falling into the IMF/World Bank Low Income Country classification. IMF Managing Director Kristalina Georgieva, together with the head of the IMF's Strategy, Policy and Review Department, Ceyla Pazarbasioglu, advocated for a "stepping up" of the Common Framework in an op-ed published on December 2021.

What ‘comparability’ should explicitly mean?

The analysis below is based on our experience with sovereign debt restructurings (most notably in Zambia and Ethiopia) and builds on a recent World Bank contribution on achieving comparability of treatment under the Common Framework[12].

There are mainly four areas where we see clarifications needed:

- *Which criteria should be used and in what circumstances?*
- *How to calculate an effort in present value?*
- *When should comparability of treatment be assessed? Who assesses it?*
- *What is the perimeter of the comparability of treatment?*

1. ***Choosing the right criteria: present value or not***

Comparability of treatment should be assessed differently in cases where debt sustainability is at stake (*e.g., Zambia*) as compared to mere liquidity problems (*e.g., Ethiopia*).

By nature, the Common Framework was designed to address debt *sustainability* issues. In such cases, the use of the three Paris Club criteria appears redundant, since the *net present value* criteria adequately captures all possible features of a debt treatment (nominal haircut, interest rate reduction, grace period, average maturity…).

The use of a single indicator to assess comparability of treatment provides enhanced transparency, and a more objective assessment that does not rely on the arbitrary application of several indicators.

It also provides for additional leeway in the negotiations, allowing debtors to accommodate creditors’ preference for early cash flows (at the expense of a nominal haircut) or long-term extension (with face value preservation). Such possible trade-offs, within the boundaries of the comparability in present value terms, can make the negotiation process more effective. This of course needs to be implemented with discernment to avoid a “*first come first serve*” situation where creditors willing to do the effort early on can be assigned all available flows during the consolidation period, leaving to the others’ the full burden of delivering the financing envelope. It however can be used to incentivize creditors to come forward first if

[12] “Achieving Comparability of Treatment under the G20’s Common Framework”, D.Rivetti, World Bank, (2022)

they want their preferences to be accommodated to a reasonable extent. This is also one of the objectives.

On the contrary, in cases where the IMF would only request a “flow treatment” designed to address a temporary liquidity issue, the present value metric does not adequately capture the relevant effort granted by respective creditors[13].

In such context, ensuring proportional contribution to the financing envelope during the consolidation period appears more relevant. Proportional contribution means that debt service deferred during the consolidation period as a percentage of total debt service due during the same period should be similar for all participating creditors. Such proportional contribution would be achieved through specific rescheduling terms to be agreed bilaterally, however in a way to avoid bunching effects in future debt service while ensuring, again with appropriate discernment, that participating creditors are reimbursed the differed amounts over similar time horizons[14]. Some limited degree of differentiation in the redemption schedule could still be tolerated to incentivize creditors to come forward early in the process.

To the extent a country does not face debt sustainability issue, there is no reason why its creditors should agree to grant it debt relief (whether in nominal or PV terms) — provided naturally that the contemplated flow treatment does not create a sustainability issue[15].

<u>Guideline 1</u>. In both cases – with the IMF determining the nature of the case – the use of a single metric to assess comparable treatments, with appropriate discernment, should increase transparency and acceptability of the debt restructuring. It should be:

- ***A PV-based metric in sustainability cases (further defined below)***
- ***A proportional contribution from participating creditors in delivering the financing envelope in liquidity cases***

2. <u>Measuring the effort in Present Value: making it (rather) simple</u>

In the case where debt is declared unsustainable, Present Value reduction is the prime method for comparison.

The method for computing the “effort” in present value granted by respective creditors is surprisingly not formally defined, which brings an additional layer of complexity and cause for disagreements in debt restructuring negotiations.

[13] Depending on how much a creditor is owed in debt service during the consolidation period (as a % of total face value of the claim), similar treatment of the total claim in NPV terms does not necessarily provide for proportional contribution to solving the liquidity issue that the debt treatment is supposed to address.
[14] To increase the acceptability in such cases, creditors should only be asked to agree a rescheduling of their maturities falling during the consolidation period, at an interest rate at least as favorable as the original interest rate of the facility. These terms would be similar to those granted by G20 creditors in the context of the DSSI, precisely designed to address temporary liquidity issue.
[15] The IMF, in the context of the IMF/WB Debt Sustainability Framework, would be the sole judge of that.

The effort is always measured by a ratio that compares the new debt and the old debt. And although there is a full range of possible approaches, all derive from two main methods: calculating the present value[16] of the "new debt" as a percentage of (1) of the nominal value[17] of the "old debt", or (2) the present value of the "old debt".

The level of complexity on the numerator and the denominator is such that reaching a consensus on how to define respective creditors' efforts in present value is illusory absent clear and transparent guidelines.

To be sure, any preferred option brings a certain degree of distortion between concessional and commercial lenders. But some are systematically and obviously biased, whereas some other are more balanced. We argue that providing a guideline, even imperfect, is better than leaving the debate open. We also take the view that simplicity and automaticity (rather than country-specificity) have their merits.

Therefore, one must consider the issue as a trade-off.

To make it simple, we consider in turn the numerator (what is being recovered?) and the denominator (what was the value of the debt before the restructuring?).

"[…] providing a guideline, even imperfect, is better than leaving the debate open"

2.1. The numerator

The debate around exit yield arises in all debt restructurings.

It can be divided into two questions:

- *Should there be a single exit yield used for all creditors, or multiple ones depending on the risk environment in which each creditor operates?*
- *What is the appropriate level?*

In the context of the Present Value-based LIC DSA Framework, the choice of the discount rate / exit yield for comparability of treatment purposes is a zero-sum game.

Agreeing on a single exit yield is not straightforward and may lead to paradoxical situations: in order to achieve comparability of treatment, creditors favoring long term rescheduling at low interest rates (usually the official creditors) may push for a high exit yield, whereas creditors favoring nominal haircut (usually private creditors) may push for a low exit yield.

[16] Including the initial economic value of possible Value Recovery Mechanisms that could be awarded to certain categories of creditors.
[17] Including Accrued / Past Due Interest capitalized as of the reference date so as to encompass in full the impact of the chosen treatment for accrued interest and PDI.

That said, the discount factor (5%) used in the IMF/WB LIC DSA Framework to determine the total relief that the restructuring is supposed to bring, seems a reasonable candidate for a single exit yield. Although private creditors might initially perceive such rate as discriminatory in their risk environment, this is in fact the least controversial rate to anchor the process.

The case for multiple exit yields is more complicated. Using the "appropriate market rate" seems to be an argument for the private sector to make.

Multiple exit yields (for instance, one for concessional debt, one for non-concessional bilateral debt and one for commercial debt) may help reflect the different risk/reward environments in which each type of creditor operates. They hold the potential to bring to the table the various realities/perceptions of pain in the effort made by each category of creditors: arguably, a long maturity extension at low interest rates is relatively more painful for commercial creditors with fiduciary duties than for bilateral creditors with concessional programs.

That said, the greater the difference between the different exit yields (assuming a higher exit yield for commercial creditors), the more distortive the burden sharing will be (in their favor).

From experience, we take the view that achieving a consensus between all creditors involved in a restructuring on what should be the respective creditors' exit yields would be a quite strenuous and cumbersome task, especially given today's fragmented and less organized landscape of creditors.

Hence, in the context of the IMF/WB LIC DSA[18], pragmatism leads us to favor a single exit yield at 5% for all creditors[19].

"[…] achieving a consensus between all creditors involved in a restructuring is a quite strenuous and cumbersome task"

<u>2.2. The denominator:</u>

The denominator should be a proxy for the value of the claim *before* the restructuring.

Given the heterogeneity in today's sovereign creditors, this value is hard to objectivize.

For marketable instruments, market prices offer *prima facie* a good and transparent proxy; but when exactly they should be observed and whether they are reflective of a well-functioning market are two very complicated questions. For non-marketable instruments, present value may be used; but the question of the discount factor to be used makes it difficult, again, to achieve consensus.

The use of nominal value offers a simple and systematic approach without however accurately reflecting the "level of pain" experienced by respective creditors.

[18] This is out of the scope of this policy brief. However, one could raise the issue whether the current LIC DSA framework is well suited for LIC countries with substantial market debt and should therefore be revisited accordingly.
[19] For simplicity purposes, we assume all claims are denominated in USD. For non-USD denominated claims, future debt service flows could simply be converted into USD using a forward curve, before applying the same 5% discount factor to assess comparability of treatment principle.

The challenge is therefore to reach an adequate level of acceptability from profoundly different classes of creditors and fairness amongst them[20] [21].

We see three options to compute the denominator, assuming numerator is set at the present value of the new debt with a unique exit yield of 5%.

"The challenge is therefore to reach an adequate level of acceptability from profoundly different classes of creditors"

Box 1. Three options to compute the effort

Option 1 ("Legalistic"):

$$PV\ Reduction = 1 - \frac{PV\ of\ the\ new\ debt\ (5\%)}{Nominal\ value\ of\ the\ old\ debt}$$

Option 2 ("Economic"):

$$PV\ Reduction = 1 - \frac{PV\ of\ the\ new\ debt\ (5\%)}{PV\ of\ the\ old\ debt\ (5\%)}$$

Option 3 ("Market-based")[22]*:*

$$PV\ Reduction = 1 - \frac{PV\ of\ the\ new\ debt\ (5\%)}{PV\ of\ the\ old\ debt\ (appropriate\ market\ rate)}$$

In today's environment, one could think that a market-based approach (Option 3) best reflects the different environments in which creditors operate and provides a better proxy to compute the "level of pain" experienced by each creditor.

Option 3 however has serious limitations:

- Having as many different "entry" yields as there are different creditors, though arguably the fairest option, is unrealistic. Achieving a consensus amongst creditors is illusory.

- It creates important distortive effects against commercial creditors: with market prices already reflecting the expected loss, using market yields as a proxy to calculate the value of the claim

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[20] At the time of HIPC, there were very few marketable instruments involved, and official creditors usually went far beyond the strict CFR, eventually up to 100% cancellation, making comparability of treatment less of an issue. That being said, the methodology was clear, and would be comparable to our Option 2 as described above (a Common Reduction Factor was determined and then applied to present value of the "old debt" using the standardized CIRR rate, that has then been substituted by 5%).

[21] In most recent sovereign debt restructurings (e.g., Greece, Ukraine, Ecuador or Argentine), only marketable instruments were restructured. The issue of comparable treatment between creditors, though not institutionalized, was therefore limited to bondholders. They were all offered the same package, regardless of the redemption profile and financial terms of their "old debt", which is comparable to "legalistic approach" described above.

[22] Alternatively, an option with appropriate market rate at the numerator can also be envisaged in a "market-based approach". However, this would deviate from the non-ambiguous 5% anchor used to compute the PV of the new debt consistently with the outcome of the IMF/WB DSA.

before the restructuring would inflict double penalty to bondholders. Moreover, how to justify using a market-based approach for the entry yield while a standardized rate at 5% as an exit yield?

- It could also incentivize creditors to call a default and exercise their acceleration rights (for those who can) as early as possible, instead of adopting a more collaborative approach towards the debtor.

For all these reasons, we do not favor a market-based approach; this leaves us with options 1 and 2 which, being both simple and systematic, reflect different approaches to fairness:

- A legalistic approach: every dollar of debt that has financed the government's budget should contribute equally to restoring the debt sustainability going forward, irrespective of the terms of the claims before the restructuring. The risk has materialized, and all counters are therefore reset to zero[23].

- An economic approach: every creditor contributes proportionally to restoring debt sustainability as defined in the IMF/WB LIC DSF. This however imposes as many different treatments as there are different debts. It prevents for instance from uniformly treating all bondholders, given their different coupon rates and amortizing structures.

We take the view that the recovery offered to creditors should not in fact depend on the terms of their claim before the restructuring**.** Calculation of respective efforts should simply be computed as a percentage of the nominal value of the "old debt" (the "legalistic" approach)**.**

What is our reasoning?

The most effective option (in terms of getting through the restructuring promptly enough) is the one that ensures simplicity and fairness. Option 1 ("legalistic") is much simpler than option 2 ("economic"): it is extremely easy to calculate[24] and corresponds to the most ordinary definition of a claim. This is also the definition that creditors (both private and public) are most familiar with.

Also, this option induces less systematic distortive effects. Indeed, in this option, the value of the official claims is not deflated by their concessional nature (long maturities, low interest rates). This is better than a situation where creditors with concessional claims may end up "subsidizing" the debt restructuring ("economic approach") in sharing the (remaining) grant element of their claims with the broader universe of creditors, thus enhancing private creditors' recovery[25].

Likewise, for private creditors, systematically reasoning "as if" the debt was accelerated (the day of the restructuring) avoids the risk of opportunistic behavior (e.g. accelerating claims with interest rates below 5%) and sets a level playing field to negotiate and deal with all bondholders at the same time rather than series by series.

Finally, a NPV calculation, as reflected in the "economic" approach could indeed tilt the balance in favor of private creditors, but would also create tensions among them, given their different coupons and maturities.

[23] This approach comes down to considering that all debts as being accelerated.
[24] In particular, using nominal value allows to circumvent the confidentiality issues faced in an increasing number of sovereign debt agreements.
[25] See the technical appendix for a more detailed explanation.

This is why bondholders restructuring practices often assume a de facto acceleration to put all classes of creditors at par.

Given the zero-sum game nature of the exercise, the choice of one option over the other is always to the advantage of one class of creditors over the other. But the "legalistic approach" is not obviously and systematically unfair to one specific category, while having the merits of transparency and simplicity.

"[…] the "legalistic approach" is not obviously and systematically unfair to one specific category"

<u>Guideline 2</u>. The method that is the most conducive to a successful negotiation is to take the face value of the debt at the denominator, and the single discount factor (5%) embedded in the IMF/WB LIC DSA Framework at the numerator. This is in our view the simplest solution that balances the most effectively the cost-benefit ratio for all stakeholders.

3. <u>A reference date for the assessment of the comparability of treatment</u>

In the context of the HIPC initiative, all calculations were made by the IMF at a reference date that was determined at the outset of the process (at Decision Point). In the context of the Common Framework, there has been no clarity given to this.

We argue that setting a calculation date early in the process would avoid the risk of creditors dragging their feet with hope that the accumulation of PDIs at a rate greater than other creditors will ultimately benefit them vis-à-vis the comparability of treatment principle.

This calculation date could either be set at (1) the cut-off-date[26], (2) the day the Common Framework was announced[27], (3) the day the debtor country officially requests to benefit from the initiative, or, where relevant, (4) the day the country defaults or declares a moratorium, or (5) the day a deal with the Official Creditor Committee is found.

Calculation date means the date on which comparability of treatment needs to be achieved. It does not mean that accrued interest / past due interest up until the actual restructuring date will not be calculated and taken into account (for the purpose of calculating public development aid delivered by bilateral partners in the context of the restructuring in particular). It will form part of the restructured amount for each creditor. It means however that the strict comparability of treatment, as defined under these guidelines, would only be respected as of this specific calculation date. The existence of as many different interest rates as the number of creditors will induce redistribution effects if comparability of treatment was to be assessed at different dates.

[26] Cut-off date in the context of the Common Framework is so far set on 24 March 2020. It could however be subject to an ad hoc determination for each debtor country if the Common Framework is perpetuated.
[27] 13 November 2020

The key objective here is to provide transparency and clarity from the outset as to when the respective creditors' efforts will be assessed for the purpose of the comparability of treatment.

Moreover, this reference date should also allow debtor countries to seek on a case-by-case basis specific liquidity buffers (such as bridge liquidity lines or new disbursements on priority projects) while leaving no ambiguity on the exclusion of such buffers from the restructuring perimeter.

"The key objective is to provide transparency and clarity"

Guideline 3. ***For setting the calculation date, we see option (3) and (4) as the most preferable ones.***

4. Referee and perimeter of application for the comparability of treatment

Some thoughts also ought to be given to determine who should be acting as referee for the purpose of assessing the comparability of treatment. Ensuring transparency, simplicity and systematicity in the definition of comparable treatment goes a long way in avoiding relentless debate around this. However, empowering one category of creditors to determine whether the sharing of the restructuring burden is adequate is not likely to maximize acceptability from all categories of creditors.

Today, creditors in search for clarity and impartiality in a sovereign debt restructuring process usually reach out to the IMF country team and/or SPR department. Though the IMF may not be willing to officially endorse this role, it is by its nature and involvement the go-to institution to play this role.

Guideline 4. ***In order to ensure a large buy-in from creditors, the assessment of the comparability of treatment should be made by a third party to the negotiations, instead of the Official Creditor Committee itself. The IMF is the natural go-to institution to play this role.***

The perimeter of the comparability of treatment is yet another source of uncertainty for debtor countries candidate to the Common Framework. The border between participating and non-participating creditors has become increasingly difficult to draw, especially when an increasing number of creditors (regional public institutions…) claim preferred creditor status.

There is a need for clarity in that regard with a set of rules that apply uniformly across cases and leaving as little room for discussions as possible.

Guideline 5. ***Sponsors of the Common Framework, in cooperation with the IMF/WB and in consultations with relevant stakeholders should clarify publicly and early in the process[28] which creditors are to be considered preferred creditors, and which others, if any, may also be excluded from the debt treatment for alternative reasons and under which conditions[29].***

[28] E.g. once the debtor country has communicated to the IMF and the WBG, the necessary information regarding all public sector financial commitments.
[29] This can for instance be the case for non-resident participants in domestic markets, to the extent their inclusion in the perimeter of the restructuring is either impossible for practical reasons, or if their inclusion is likely to deteriorate rather than improve the country's financial and external position.

Conclusion: how to revive traction?

The G20 and Paris Club countries' announcement of the Common Framework for Debt Treatment in November 2020 was a breakthrough in the international architecture for sovereign debt restructuring. It set out important principles to ensure broad-based participation to sovereign debt resolution.

However, 18 months later, and despite some progress achieved occasionally here and there, the three applicant countries are faced with protracted discussions with and between the various stakeholders. The lack of any implementation decree setting the concrete and exact rules governing the initiative, and notably how to implement concretely the comparability of treatment principle, is certainly one explanation, though not the only reason, to this lack of progress. This impedes cooperative creditors to move ahead with the restructuring of their claims, absent clear guidelines governing the definition and perimeter of application of the comparability of treatment principle i.e., the distribution of debt relief across creditors.

The attempt to handle such a critical topic on a country-specific basis, waiting for each *ad hoc* Official Creditor Committee to make its own determination of what comparable treatment means and implies precisely, is unlikely to be effective. It creates a lot of frustrations for creditors – be they private or official – but also for debtor countries, possibly disincentivizing other countries to request treatment.

We believe that participating Paris Club and G20 countries should come up with a joint set of guidelines, adopted after consulting with the IMF and the World Bank, called upon to play a more pivotal role in the process, as well as representatives from the private sector (e.g., the IIF, bondholders' committees…).

These guidelines, which would not constitute absolute rules, would be used with appropriate discernment to guide stakeholders involved in a Common Framework debt restructuring process, and incentivize them to come forward early on. The existence of such guidelines is not supposed to entirely substitute the current flexible approach that can sometimes unlock specific situations. They should be used with pragmatism and judgement.

In particular, one way of introducing some flexibility in the application of these guidelines would be to consider that comparability of treatment does not need to be strictly respected between each and every creditor, but instead assessed at the higher level of creditors' groups or categories. This would allow to accommodate some flexibility in specific cases where the strict application of the comparability of treatment on a specific debt might prove counterproductive.

All in all, we believe that bringing transparency, clarity and simplicity, as it was the case in the context of the HIPC initiative at the time, with a touch of discernment and flexibility, would strongly benefit the ongoing country cases and may allow for a more seamless engagement with all stakeholders, including early participation from private creditors where possible.

We recognize however that, like Rome (or the HIPC initiative), the Common Framework cannot be built in a day, nor a year. We are confident that official stakeholders will collectively strive to make the Common Framework more efficient going forward. This paper is intended as a modest contribution to the debate which hopefully could serve as an anchor to more substantial discussions to come.

Summary of our proposed guidelines

- ***Guideline 1.*** ***Comparability of treatment should be assessed based one single metric, depending on the nature of the debt distress, and with appropriate discernment***
  - *In case of temporary liquidity constraint, the contribution to the financing envelope during the consolidation period should be proportional across creditors*
  - *In case of debt unsustainability, the efforts in Net Present Value terms should be comparable between creditors*
- ***Guideline 2.*** ***In the latter case, creditors' efforts should be comparable when computed in the following way:***

$$PV\ Reduction = 1 - \frac{PV\ of\ the\ new\ debt\ at\ 5\%\ discount\ factor}{Nominal\ value\ of\ the\ old\ debt}$$

- ***Guideline 3.*** ***The reference date that serves in assessing the comparability of treatment should be set either on (i) the day the debtor country officially requests to benefit from the Common Framework, or, where relevant, on (ii) the day the country defaults or declares a moratorium***
- ***Guidelines 4 & 5.*** ***A third-party assessment of the comparability of treatment should be undertaken by the IMF:***
  - *Ex ante, the IMF would determine the appropriate perimeter of the comparability of treatment*
  - *Ex post, the IMF would assess whether the application of the comparability of treatment has been satisfactory, with credible mechanism to invalidate a debt treatment*
- ***These guidelines should be agreed upon and publicized by G20 countries and Paris Club Members, after appropriate consultation and buy-in form all stakeholders, in the form of an "decree of implementation" associated to the G20 13 November 2020 decision, and recognizing the difficulty encountered to date.***

Technical Appendix

<u>Box 2. Why the Economic Approach would induce implicit subsidy from official creditors to private creditors compared to option 1</u>

Let's suppose that a country seeks to finance USD 200 of expenditures and subsequently borrows USD 200 (nominal value, "NV"). However, rightly after the disbursement, as part of their DSA assessment, the IMF and the WB indicate that the maximum Present Value ("PV") of debt that the country can support is USD 100. In this example, all PVs are computed at a single identical discount factor ("Standard DF"), unless otherwise indicated.

<u>Case A</u>*<u>: The country is indebted towards non-concessional lenders only</u>*

- The non-concessional facility has a nominal value of USD 200; the present value of the non-concessional facility post-restructuring is denoted X
- In this case, to comply with IMF DSA constraint, we need $X = 100$, and the PV recovery of the non-concessional lender is therefore $\frac{X}{200(NV)} = 50\%$

<u>Case B</u>*<u>: The country is indebted towards both concessional and non-concessional lenders</u>*

- The concessional facility has a nominal value of USD 100, and a pre-restructuring present value of USD Y'; the present value of the concessional facility post-restructuring is denoted Y
- The non-concessional facility has a nominal value of USD 100, and a pre-restructuring present value of USD X'; the present value of the non-concessional facility post-restructuring is denoted X

- ***<u>Option 1 (Legalistic approach):</u>*** *Comparability of treatment assessed relative to the <u>nominal value</u> of the initial claim*

Comparability of treatment: $\frac{X}{100(NV)} = \frac{Y}{100(NV)}$ *IMF/WB DSA constraint:* $X + Y = 100$

- In case A, $X = Y = 50$, and the recovery of the non-concessional lender is: $\frac{X}{100(FV)} = 50\%$

- ***<u>Option 2</u>*** *<u>(Economic approach):</u> Comparability of treatment assessed relative to the <u>present value</u> of the initial claim*

Comparability of treatment: $\frac{X}{X'} = \frac{Y}{Y'}$ *IMF/WB DSA constraint:* $X + Y = 100$

- In case B, $Y = X * \frac{Y'}{X'}$, and the recovery of the non-concessional lender is: $\frac{X}{100(FV)} = \frac{1}{1+\frac{Y'}{X'}} > 50\%$ if and only if $Y' < X'$, which is always true with the Standard DF since Y' represents the PV of a concessional facility

<u>Conclusion #1</u>: When the comparability of treatment is assessed based on the nominal value of the initial claims (*legalistic approach*), the recovery of the non-concessional lender is the same, regardless of the universe of creditors (i.e. is the same in cases A and B). On the contrary, when assessed based on present value (*economic approach*), the existence of official creditors lending at concessional terms is distortive insofar as it improves the recovery of the non-concessional lender.

<u>Box 2 (bis). Why the distributive impacts between market-based approach and legalistic approach are ambiguous –</u> <u>*Continued illustrative example*</u>

- *Memo: In Option 1, the recovery of the non-concessional lender is:* $\frac{X}{100(FV)} = 50\%$

- ***<u>Option 3</u>*** <u>*(market-based approach):*</u> *Comparability of treatment assessed relative to the <u>present value</u> of the initial claim, <u>at different discount rates</u>*

  – The Standard DF is used both at the numerator and the denominator for the concessional claim

  – For the non-concessional claim:

    - The ratio of the present value of the restructured claim at the negotiated "exit yield" (numerator) to the present value of the restructured claim at the Standard DF is denoted α. This generalizes the "Option 3" envisaged in the paper, in which the entry yield is equal to the Standard DF

    - The ratio of the present value of the claim before restructuring at the negotiated "entry yield" (denominator) to the present value of the claim before restructuring at the Standard DF is denoted β

    - In general, the entry yield is higher than the exit yield, which is larger than the Standard DF used to discount the concessional facilities. Therefore, - and assuming that the shape of the payment schedule is broadly similar between the non-concessional claims pre- and post-restructuring - we have $0 < \beta < \alpha < 1$

Comparability of treatment: $\frac{\alpha X}{\beta X'} = \frac{Y}{Y'}$ *IMF/WB DSA constraint:* $X + Y = 100$

  – In case B, $Y = X * \frac{Y'}{X'} * \frac{\alpha}{\beta}$, and the recovery of the non-concessional lender (at the Standard DF) is: $\frac{X}{100(NV)} = \frac{1}{1+\frac{\alpha Y'}{\beta X'}}$

  – This recovery rate for the non-concessional lender is higher than 50% if and only if $\frac{Y'}{X'} < \frac{\beta}{\alpha}$, which is indeterminate and will depend on the differences between the Standard DF, the entry yield and the exit yield for non-concessional lenders

<u>Conclusion #2</u>: If different discount rates are allowed, it is not clear what class of creditors would be most favored with the *market-based approach* (instead of the *legalistic approach*), and this will ultimately depend on the gap between the negotiated exit yield and the negotiated entry yield of both type of creditors. Hence, negotiations between concessional and non-concessional creditors on these parameters would dramatically lengthen the restructuring process with no possible systematic approach.

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