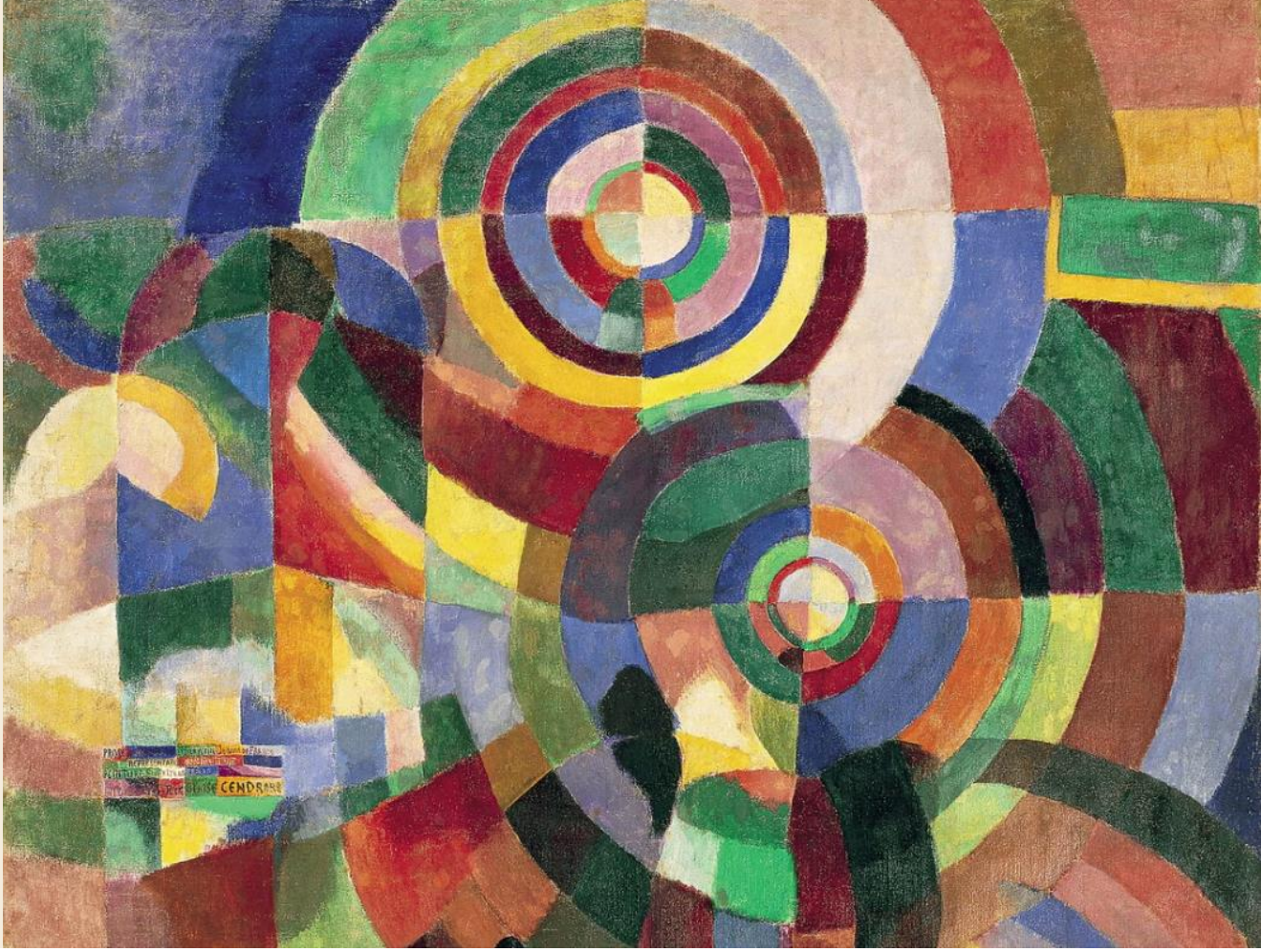

POLICY BRIEF

Sovereign Debt – Towards More Complex and Costly Capital Structures?

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Image credit: Sonia Delaunay, Prismes électriques, 1914.

Abstract. *The liability side of a sovereign's balance sheet has historically been simple, certainly as compared to banks and, to a large extent, corporates. This is changing, especially for emerging and frontier-market economies. Their capital structures are becoming increasingly complex because of an intricate and largely implicit hierarchy of claims, and because of the proliferation of contingent instruments that generally make their debt less predictable.*

Two consequences are likely. First, a future impact on the overall cost of debt: absent clarity on the hierarchy of claims, which inevitably increases the loss given default for the least-senior creditor, and unless the shock-absorptive virtue of contingent instruments outweighs their complexity and unpredictability, the odds are that countries will pay a complexity/uncertainty premium. Second, an impact on markets' efficiency and restructuring feasibility: an unmapped, uncertain liability stack is one the IMF cannot properly analyze, one the markets cannot price, and one that a debtor and a creditors' committee cannot restructure without years of delay. The policy response is not to resist diversification but to discipline it, promoting the contingent and transparent forms while containing the opaque and subordinating ones.

Introduction

For most of the post-Brady era, the sovereign capital structure could be described in a sentence: plain debt and no equity-like instruments. The hierarchy was legible, multilateral institutions at the top by convention, Paris Club bilaterals and commercial banks below them at broadly equivalent rank. Creditors coordinated well through the Paris and London Clubs, and a debtor's capital structure was simple enough for a debt sustainability analysis to properly function.

The simplicity of sovereign capital structure is eroding, and the central question of this paper is whether it is changing for the better. We argue that it is not, unless the changes are actively governed.

We proceed in two parts: first, why the capital structure of governments is becoming more complex; second, what can be done about it.

1. Why is the capital structure of governments becoming more complex?

1.1 The explicit and implicit hierarchy of claims

The international community has spent an inordinate amount of time over the last five years debating what "Comparability of Treatment" should mean in the context of sovereign debt workouts. The debate has produced protracted processes and a wave of state contingent or value recovery instruments (see 1.2).

Yet, in the meantime, the debt structure has become more unequal rather than less. A nominally "senior" unsecured creditor increasingly finds itself subordinated in substance.

It is worth setting out the new, tentative and unofficial ranking of claims that applies when an issuer cannot repay, from the most protected claim to the least.

1. The **International Monetary Fund**: top of the list, based on the analogy with a central bank as a last resort and protected lender to domestic banks in distress.
2. **Multilateral development banks with undisputed preferred creditor status** (PCS), e.g. the World Bank or the African Development Bank. This is not bullet-proof protection. In practice it means that if these institutions stand ready to provide net financing at concessional terms throughout an IMF programme, they will not bear any direct losses.
3. **Commercial creditors guaranteed by an Aaa multilateral development bank.** If anything goes wrong, they are repaid in full and on time. The guarantee makes them, in practice, one of the most protected claimants in the structure. This is true for the portion of the claim that is guaranteed, but PCS does not extend to partially-guaranteed structures as evidenced by the case of Ghana's 2030 Eurobond *(see Lazard's policy brief from October 2025, Anatomy of a Restructuring: The World Bank Ghana 2030 Partially Guaranteed Eurobond).*

4. **Collateralised creditors.** Their effective seniority is a function of the adequacy and actionability of the collateral. Such collateral usually consists of an asset of the borrowing government. A collateralized structure can be used by bilateral or commercial creditors. In the case of recent sovereign total return swaps (TRS), it oddly consists of a liability of the government: in default, the sovereign hands over more of its own debt to the creditor in order to improve the recovery. That said, accessing collateral does not mean full protection. Official creditors can still ask for indirect compensation from these creditors as it is unclear how such collateral is assessed from the point of view of Comparability of Treatment.
5. **MDBs with strong but not water-tight preferred creditor status.** Typically, regional MDBs with no universal membership, which may on rare occasions be caught in a restructuring, usually because of their near-commercial financing terms. Even so, their loss experience is markedly lower than that of any commercial creditor, given the nature of their portfolios.
6. **Unsecured creditors bilateral and commercial lenders (loans and bonds).** The residual claim, and the one that absorbs the consequences of everyone else's protection.

Much of the comparability-of-treatment debate sets these last two categories at loggerheads. In practice, however, a large share of the debt involves creditors who are not subject to comparability at all, which is precisely why the unofficial ranking matters more than the official one.

Note that this ranking is bound to become more significant over time, for a structural reason. One of the most popular policies among MDBs is to offer guarantees to commercial lenders, in order to attract them into financing developing countries at affordable conditions. This is a powerful way to multiply development finance. But it also enlarges the protected portion of the debt stock and rigidifies the capital structure. Indeed, when commercial lenders activate their guarantee in a debt restructuring, the next step is for the guaranteeing MDB to turn on the government with its preferred creditor status. **Commercial claims thereby metamorphose, at the moment of distress, into superior MDB claims, and, all else equal, the recovery on unsecured creditors'claims falls.**

A previous Lazard paper in this series addressed this "preferred-creditor-status glut" issue: not everyone can enjoy a preferred status when there are many privileged creditors and the repayment capacity is severely constrained *(Lazard's policy brief from June 2025: The Preferred Creditor Status glut – The search for loss absorption in Africa)*. **To be sure, the tentative hierarchy of claims presented above is not stable. There is competition amongst the creditors to climb the scale. Three forces in particular are stretching the hierarchy:**

Contested ranking. The largest new creditors increasingly refuse to be classified. China, chiefly through its policy banks and China Eximbank, is now the largest bilateral creditor to low- and middle-income countries, and, in a majority of distressed situations, the single largest official bilateral lender; Gulf lenders, India and assorted state-linked entities add to the pool. A policy-bank loan can be presented as official (and so inside the comparability perimeter) or as commercial (and so subject to the Comparability of Treatment principle), depending on what

suits the lender. This ambiguity matters because it determines who sits at the table, on what terms, and in what sequence, directly shaping the pace and conditions of any coordinated resolution. The cost is visible in the Common Framework: of the four applicants, Chad, Ethiopia, Ghana and Zambia, each met delays. Delays were more important for Zambia and Ethiopia where China is the dominant bilateral lender.

Occult seniority. Collateralised and resource-backed loans create seniority that may be real but frequently undisclosed. One widely cited study identified 52 resource-backed loans signed between 2004 and 2018 worth more than USD 164 billion, of which some 30, worth around USD 66 billion, went to sub-Saharan Africa, with roughly half of that amount supplied by China's two policy banks.[1] Angola alone had borrowed more than USD 20 billion against future oil shipments by 2011.[2] Crucially, only about half of the loans examined could be located in the World Bank's Debtor Reporting System, and some were booked not as debt at all but as advance payments to a supplier, outside the statistics entirely.[3] **The systemic hazard is a race to collateralize:** if pledging a revenue stream reliably moves a lender up the waterfall, every creditor demands the same, progressively subordinating whoever lent unsecured and earliest.

Domestic debt's fungibility. Historically, sovereign borrowing was clearly divided: domestic residents held local-currency debt issued under domestic law, while foreign investors held foreign-currency debt governed by foreign law. Because the holders, currency, and legal framework largely aligned, the legal definition of debt (based on governing law and jurisdiction) and the economic definition (based on the residence of the holder and currency) effectively referred to the same instruments. Financial globalization has blurred this distinction: foreign investors now frequently buy local-currency, domestic-law debt, while domestic investors often hold international sovereign bonds. As a result, **the traditional categories of "domestic" and "external" debt have become unbundled,** making frameworks that focus mainly on foreign-currency bonds under foreign law increasingly outdated. This shift is reinforced by the upcoming IMF's revision of the Low-Income Country Debt Sustainability Framework (LIC DSF), which places greater emphasis on total public debt and gross financing needs rather than solely external debt. In restructuring contexts, this broader lens raises difficult questions about burden sharing (and hence seniority) between domestic and external creditors and risks encouraging a search for strict "equal treatment" across creditor groups, an objective that may prove impractical, prejudicial to financial stability and potentially complicate already complex sovereign restructurings[4], as evidenced in Lazard's previous policy paper on domestic debt restructuring *(Lazard's policy brief from September 2023 – Domestic Debt Restructuring: An Exercise in Laser Surgery).*

[1] Approximately 52 resource-backed loans signed 2004–2018, totalling more than USD 164 billion; around 30 (about USD 66 billion) to sub-Saharan Africa, roughly half from China Development Bank and China Eximbank. NRGI (2020); Mihalyi et al., World Bank (2022).

[2] Angola had borrowed more than USD 20 billion against future oil shipments by 2011. NRGI (2020).

[3] Only about half of the resource-backed loans examined appeared in the World Bank Debtor Reporting System; some were recorded as supplier advances rather than debt. Mihalyi et al., World Bank (2022).

[4] Domestic and External Debt: The Doomed Quest for Equal Treatment. Ana Gelpern and Brad Sester. 2004.

A first conclusion. These developments raise two questions with respect to pricing.

First, one could expect the risk of subordination to impact bond spreads, bonds being arguably at the bottom of the food chain. Yet, this is not apparent today in emerging markets: bond spreads are close to their historical tights. This may mean that such risk premium is overwhelmed by renewed optimism vis-à-vis the asset class, or pure diversification; **or that such risk is still underpriced.**

Second, it will be important to monitor the extent to which the premium investors charge on de-facto-subordinated commercial debt will outweigh the discount the borrowing government obtains on the debt it has dressed in preferential treatment.

1.2 The proliferation of contingent instruments

As an earlier paper in this series argued (*Lazard Policy Brief from January 2025: The 2020-2025 Sovereign Debt Crisis: What have we learnt and what lies ahead?*) that the lack of trust among actors in restructuring negotiations has driven a bout of frenetic financial innovation in the form of contingent instruments. They fall into two broad families.

Creditor-protective instruments. A first sub-type stems from distrust of IMF projections, which bondholders now routinely challenge and that are, after all, decisive for the size of their losses[5]. This has produced instruments designed to compensate creditors if the debtor's economy turns out healthier than forecast (value-recovery instruments and other upside-linked claims). A second sub-type stems from distrust among creditors themselves, and takes the form of compensatory or most-favored-creditor clauses that trigger if one group ends up better off than another. Both are probably inevitable in current conditions, but both are problematic for debtor countries, which in the past simply pocketed any upside. The capital structure becomes more complicated and the debt dynamic less predictable, full of non-linearities (cf. opaque margin calls on TRS…), which again raises the question of the premium the country will pay when it returns to the market.

Debtor-protective (state-contingent) instruments. A second family is aimed at improving the debtor's position rather than the creditors': GDP-linked bonds, climate-resilient debt clauses or broader debt suspension clauses as recently laid out by the London Coalition[6] that insulate governments from external shocks (climate, commodity, financial). These are better intended (as vulnerable countries do, in our view, need help to absorb shocks) but are rarely a game-changer because they typically apply only to a subset of the debt and so are insufficient to move the needle on overall creditworthiness.

The distinction that should drive policy is not new-versus-old but contingent-and-transparent versus opaque-and-subordinating. Used well, state-contingent instruments build automatic relief into the contract instead of forcing a default-then-renegotiate cycle; used poorly, the

[5] See for instance: The Product Of All Fears: IMF's USD GDP Forecast Quality During EM Bond Restructurings. Pijus Virketis. January 2024.

[6] Broad Debt Pause Clauses and Increased Transparency in Emerging Markets Sovereign Bonds. A Proposal from the Bondholder Working Group. The London Coalition. April 2026.

creditor-protective variety simply layers further uncertainty onto an already crowded structure.

1.3 The opaque creditor: synthetic exposure and the empty creditor

A third strand of complexity dissolves the link between who bears the risk and who holds the claim. Total return swaps and related synthetics let an investor take on the economic exposure of a bond without appearing on the register, and let the nominal holder shed the risk while keeping the legal claim, and the vote. This creates two blind spots. On the debtor side, exposure routed through swaps can sit outside the measured debt stock, so the sustainability analysis understates true claims. On the creditor side, it produces the empty creditor, and in its sharpest form the net-short creditor, who votes in a restructuring while having hedged away, or even reversed, the underlying exposure. A creditor who profits from default has every incentive to block a deal the other holders need.

The central question. Across all three strands, the same economic question recurs: is the added complexity and uncertainty likely to raise the cost of debt? Two further system-level costs reinforce the worry. The debt sustainability analysis loses its anchor, because it is only as good as the liability map beneath it, and hidden collateral, undisclosed margin calls, off-balance-sheet swaps and unreported quasi-commercial loans leave that map incomplete. And Comparability of Treatment, the load-bearing principle of coordinated restructuring, becomes hardly measurable when some claims are secured invisibly and some creditors' true net exposure is masked by derivatives.

2. What can be done?

The complexification of the sovereign capital structure is, at bottom, a search for protection, mostly by creditors who want to be better secured, occasionally by issuers who want to be better insulated against shocks.

It carries serious drawbacks:

- It makes the debt harder for the Debt Management Office to manage;
- It makes the debt harder for commercial lenders to price;
- It therefore risks confining the country's debt to specialized funds rather than large generalist funds, reducing demand and keeping price elevated;
- It is bound to make any future restructuring extremely difficult;
- It increases the risk of litigation to the extent the revelation of hitherto hidden claims is bound to create unhappy losers amongst creditors; and
- Above all, it may raise the cost of debt, as investors will likely end up pricing the risk of sitting low in the waterfall, the opacity of collateralised lending, and the cost of any protection sold to the issuer.

Assuming there is indeed a complexity-and-uncertainty premium, five measures follow. They are ordered to mirror the sources of the problem set out in Part 1.

1. **Clarify the preferred creditor status.** While a famous historical French quip is that "one always renounces to ambiguity at his own expenses", it looks like the ambiguity surrounding which multilateral institution should have a privileged status or not has outlived its benefits. There is a case for a clear, public statement of which institutions enjoy preferred creditor status, and in which circumstances. The right dividing line is in our view between profit-driven and non-profit-driven institutions, rather than the cost of their loans, which may simply reflect different balance sheets and shareholder structures. That said, every MDB and bilateral concessional lender should assess where it stands in the waterfall, recognizing that not all creditors can be privileged when repayment capacity is heavily constrained.
2. **Make transparency enforceable.** IMF programmes and MDB financing should be conditioned on disclosure of the entire liability structure, including collateral arrangements, contingent and guaranteed liabilities of state-owned enterprises, and derivatives that reference the sovereign. Statistics, in turn, should record economic substance, capturing swap exposures and supplier-advance resource loans as the debt they are.
3. **Restore an enforceable, collateral-aware cascade.** Negative-pledge covenants, routinely circumvented by official collateral structures, should be redrafted to bite on resource-backed and escrow arrangements. Secured claims should be identified as such in the DSA, and their security netted out in any comparability calculation, otherwise a fully collateralised lender that takes a nominal haircut gives up nothing. The IMF's Debt Limits Policy should be updated to capture collateral and the economic substance of swaps, and "official bilateral creditor" should be defined robustly enough that quasi-commercial state lenders cannot opt in or out of the comparability perimeter at will.
4. **Simplify the structure over time.** Countries should retire creditor-protective contingent instruments as early as they can, and call-back (buy-back) options should be written into the contracts from the outset. The aim is not to deprive creditors of a deserved bonus, but to simplify the capital structure and avoid discouraging future investors with hidden debt dynamics. Zambia's current liability management exercise, combining an early retirement of its post-restructuring contingent instrument with a debt-for-energy swap, offers a nascent illustration of this principle in practice.
5. **Enhance debt-profile analyses.** Debt Management Offices should publish projections of their debt profile under a range of scenarios including in relation to contingent liabilities, so that investors can make informed bets when they buy the new debt, directly attacking the opacity premium.

These measures share one logic: promote contingent and transparent diversification, and contain opaque and subordinating diversification. Diversification of the liability side is not, in itself, the disease; unmapped subordination and unpriced complexity are.

Conclusion

The diversification of emerging-market sovereign liabilities is usually framed as a financing-access story. It is better understood as a governance and pricing story.

The old architecture worked not because the instruments were simple but because the seniority cascade was known, the creditors were coordinated, and the stock was transparent enough to analyze. Each new layer, guaranteed and collateralized claims, contested official rank, synthetic and contingent exposures, removes one of those conditions, and the bill may arrive in two currencies: a higher risk premium on the debt the country issues, and slower, messier restructurings when a debt default is inevitable.

The remedy is to govern the complexity rather than to wish it away: rationed preferred status, transparency made enforceable, a collateral-aware cascade, a simpler and more legible instrument set, and a restructuring toolkit that can actually bind the parties. Done well, the genuinely useful innovations survive; the quietly corrosive ones do not.

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 compels us to share our decades of experience for the broad public interest.

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