POLICY BRIEF

Getting Sovereign Debt Restructurings out of the Rut in 2023: Three Concrete Proposals

February 2023

LAZARD

Note: Lazard has prepared the information herein based upon publicly available information. The information herein is provided for general informational purposes only and is not intended to be, and should not be construed as, financial, legal or other advice and Lazard shall have no duties or obligations to you in respect of the information.

Executive Summary

In November 2020, the G20 adopted the Common Framework for Debt Relief, hoping to better coordinate debt-relief initiatives for the lowest income countries. This new framework was designed to respond to a new market reality: the types of commercial, multinational and especially Sovereign creditors, with the emergence of China as a leading creditor, has expanded over the years. Coordinating these different groups – each with its own interests – had become harder. Enter the Common Framework, which was intended to be an efficient platform for balancing and quickly responding to these interests.

More than two years later, the Common Framework has failed to provide decisive momentum to debt reduction negotiations – although arguably the debt restructuring outside the Common Framework are equally unsuccessful. There is in fact a broader critique emerging that an implicit preference may be given by the international community for extensive debt surgery and picky inter-creditor equity over expeditious processes.

It is possible, but far from certain, that the 2022 debt restructurings in places such as Sri Lanka and Ghana will be completed more quickly. If this is not the case, the risk is that the framework will in the long run produce the opposite outcome of its original purpose: countries in debt distress, facing the unpalatable prospects of long, distractive and crippling negotiations, will decide to postpone the inevitable and continue servicing unbearable debt burdens. Or they might opt for fast-tracked deals with a subset of their creditors, outside any coordinated international framework.

Drawing on Lazard's first-hand experience advising countries on debt restructurings, this policy paper reviews the three main obstacles to expeditious restructurings and proposes three concrete solutions to get sovereign debt restructurings out of the rut in 2023.

We believe that a fast restructuring should be the overriding priority for all stakeholders involved because the cost of the paralysis only adds to the economic distress of the indebted country. To complete these restructurings, we argue that it is expedient to allow creditors to get more recovery in the future should ultimate conditions allow. We also advocate for the insertion of clauses that incentivize creditor groups to seek early debt restructuring deals and to get around the current IMF 'financing assurances' stalemate in a radical way.

Note: Lazard has prepared the information herein based upon publicly available information. The information herein is provided for general informational purposes only and is not intended to be, and should not be construed as, financial, legal or other advice and Lazard shall have no duties or obligations to you in respect of the information.

Introduction

Many low-income countries started borrowing in international capital markets over the last 15 years. While their credit ratings were often very low, they benefitted from both the historical decline in world interest rates and a significant compression in the risk premium for emerging markets. Overall, these countries have been able to raise Eurobonds at conditions that were not significantly dissimilar to the concessional loans of the 1990s.

The secular decline in global interest rates has come to a halt in 2022 with a resurgence of high inflation rates across the world. The rapid tightening in global financing conditions has followed two major macro-economic shocks of unprecedented nature – the COVID-19 crisis, and Ukraine war and commodity price shock. These profound changes in the global macroeconomic landscape have exacerbated fiscal and external vulnerabilities for many emerging and frontier economies, calling into question the existential merits of market funding.

The difficulty, if not impossibility, of refinancing the bonds issued in the last decade at affordable conditions is a major policy issue for most developing countries rated single B and below... Arguably, Africa, where the majority of low credit quality countries are located, is the most affected region. The larger emerging market economies in Brazil, Mexico, India, South Africa and Indonesia have a longer experience with capital markets and a low share of foreign-denominated public debts, and so far have only been moderately affected. The cases of Turkey, Argentina and Russia are largely idiosyncratic.

This situation raises the stakes for designing effective sovereign debt restructuring processes, notably for emerging frontier markets[1].

However, the ambition should remain realistic and achievable: Sovereign debt restructurings have always been complex and the multiplying types of creditors that came with this expanding indebtedness only made matters worse.

Lofty projects such as an institutionalized international process (cf. the Sovereign Debt Restructuring Mechanism), were overly ambitious 20 years ago. Now they are completely out of reach.

Today most processes are severely delayed, with Zambia lasting beyond 30 months and Suriname 27. These delays have severe consequences for governments and the hundreds of millions of people they serve. Often finance ministers do not even remain in power long enough to execute their plans.

[1] "Government Debt in Rough Waters - A Navigation Guide", Lazard, September 2020

Note: Lazard has prepared the information herein based upon publicly available information. The information herein is provided for general informational purposes only and is not intended to be, and should not be construed as, financial, legal or other advice and Lazard shall have no duties or obligations to you in respect of the information.

Protracted processes are disconnected from the urgent policy agenda of countries in crisis. They prevent authorities from planning ahead and restoring confidence to financial and industrial partners. The absence of an anchor such as an IMF program with the associated financing complicates further already distressed situations in terms of output losses, inflation, dearth of foreign reserves, lack of fiscal space etc..

Worst of all, these protracted periods threaten to discourage countries from taking their responsibilities when debt becomes unbearable — and ultimately delay an unavoidable outcome. **This is a major public policy issue: ineffective debt workouts discourage sound policy decisions. This risks multiplying the number of ad hoc suboptimal separate deals with powerful creditors.**

Lazard has been advising most of the governments engaged in orderly debt restructurings over the last 3 years, including Suriname, Ghana, Sri Lanka, Zambia, Ethiopia, Ecuador, Argentina, Lebanon and can offer some general insights from its on-the-ground experience.

Why do current Sovereign debt restructurings stall?

Debt restructurings stall for three main reasons:

- The actors (the debtor, the IMF and the various creditors) do not agree on the quantum of debt relief needed to restore debt sustainability;
- Even if they agree on the necessary quantum of debt relief, each creditor is worried about contributing disproportionately to the restructuring effort (issue of comparability);
- The fluidity of the process is further complicated by the fact that IMF lending (critical in the post-restructuring recovery of the country) is conditioned on an IMF board decision, and that convoking the IMF board is itself conditioned on the existence of 'financing assurances' from bilateral creditors (inter alia). The current approach de facto gives recalcitrant/undecided bilateral creditors a veto right before the restructuring negotiation even starts.

Note: Lazard has prepared the information herein based upon publicly available information. The information herein is provided for general informational purposes only and is not intended to be, and should not be construed as, financial, legal or other advice and Lazard shall have no duties or obligations to you in respect of the information.

Arguably there seems to be another 'Inconsistent Trinity' in international finance in trying to achieve, simultaneously: (i) an expeditious restructuring, (ii) that delivers adequate debt relief and (iii) respects inter-creditor equity. Something has to give.

The international community seems to have implicitly given precedence to (ii) and (iii) at the expense of (i). Creditors usually challenge the IMF for its 'overly' conservative assumptions which aim at achieving a lasting resolution that eliminates repetitive defaults, but come at the risk of not getting a consensual debt reduction at all. This trade-off — essentially total amputation or nothing — must be better explored and re-calibrated with more reasonable expectations

We lay out three concrete policy options to recalibrate these trade-offs to achieve a faster resolution:

1. Narrowing the gap between the debtor and creditors on the required quantum for debt relief

Agreeing on the necessary quantum of relief supposes converging on the definition of debt sustainability. It is a very complex issue: some countries can bear a larger debt than others, either because their refinancing risk is low and/or because they can tolerate giving preference to debt service against what they view as elementary social needs.

The IMF has a methodology that applies to low-income countries (LICs) and one that applies to market-access countries (MACs)… and a grey zone for those countries that fall in the middle. There are debt thresholds determining the level above which public debt is no longer deemed sustainable in terms of stock and flow. Yet, obviously, defining a clear frontier between solvency and insolvency is fraught with difficulties.

This has become even more striking over the past few years: various updates to the debt sustainability frameworks have profoundly differentiated the LIC and the MAC countries' methodologies, the former now being increasingly rigid and prescriptive on creditors while the latter has become more opaque and somewhat arbitrary.

As a result, the role of the IMF as the ultimate umpire, and the authority of its Debt Sustainability Analysis, are increasingly being challenged.

The inherent difficulty in identifying the tipping point beyond which debt is unsustainable, combined with the uncertainty of macroeconomic forecasting, explain why creditors will always find some ground to challenge the sacrifice they are asked to consent to.

Note: Lazard has prepared the information herein based upon publicly available information. The information herein is provided for general informational purposes only and is not intended to be, and should not be construed as, financial, legal or other advice and Lazard shall have no duties or obligations to you in respect of the information.

How might progress still be achieved?

- One approach is to further refine the concept of debt sustainability, better objectivize it and generate broader consensus on the matter. This is the approach recently taken by the IMF with the publication of their guidance notes.
- Another approach for market-access countries is to define the sustainable debt stock as the one that will, all things being equal, be consistent with a desirable and realistic level of credit rating and the associated interest rate spread. Although this is not an objective yardstick, it is a neutral one.
- Still another approach is to resign oneself to the fact that creditors will not agree with the prescribed sustainable debt boundary and let them select their own plausible macroeconomic and financial scenario. More positive scenarios obviously require a lower quantum of debt relief. The debt restructuring would then rely on the more severe macro-scenario underpinning the IMF program. But, as a complement to the new restructured bond, there would be a 'compensation bond' given to the creditors, with no short-term cash flows. Should the more positive macro- scenario materialize in 2-3 years, the compensation bonds would start paying cash flows. This would be like a Value Recovery Instrument except that it would be a simple, small size, capped fixed-income instrument with the same characteristics as the exchanged bond: it would become payable if, and only if, the more sanguine macroeconomic assumptions defended by the creditor committees during the negotiation pan out. Creditors with preposterous economic assumptions would never cash in the compensation bond. On the other hand, should the conditions be met for the compensation bond to become payable, the debtor country would end up repaying more to its creditors, but in strict proportion to its improved creditworthiness.

2. Enforcing inter-creditor equity

The second reason why Sovereign debt restructurings often stall is the question of inter- creditor equity, i.e. whether the treatment of all creditors is deemed comparable. This is also a complex matter: multilateral lenders argue they should have a preferred creditor status; bilateral lenders argue that the concessional nature of their loan justifies a differentiated treatment; the central bank and the local banks argue that they are too systemic to be involved in the restructuring; bondholders argue that their claim must remain marketable, objecting to any material deviation from what the hypothetical exit yield might be. In the face of such warring expectations, defining comparability is a daunting task.

Note: Lazard has prepared the information herein based upon publicly available information. The information herein is provided for general informational purposes only and is not intended to be, and should not be construed as, financial, legal or other advice and Lazard shall have no duties or obligations to you in respect of the information.

There are several reasons why assessing comparability is complex.

- First is the question of how to discount the pre- and post-restructuring claims of each group of creditors. The key ratio compares the present value of the new debt to either the present value of the old debt or its nominal value. While it would be ideal that all groups of creditors agree ex ante on a single discount rate to determine how comparable their respective efforts are, this is extremely challenging in practice. To us2, a good option is to compare the PV of the new debt at 5% (i.e. the interest rate used by the IMF for the DSA) against the nominal value of the original claim. As explained in our previous Policy Paper, this is the least worst solution3.
- Second is the question of the perimeter of the restructured debt. Arguably, a major comparability issue is when creditors enjoy a de jure or de facto senior status: this is the case of the IMF and some other preferred multilateral creditors. But this is also often the case of domestic creditors, essentially the banking system, the central bank and Pension funds, if any. Not bringing them into the negotiation creates a clear issue of comparability of treatment. At the same time, imposing losses to the banking system at the risk of damaging confidence in the currency and generating financial instability may end up as a Pyrrhic victory for external creditors. In the end, the need to use public funds to recapitalize the banking system – and its ensuing shocks -- leaves even less capacity to repay foreign creditors… So financial stability must be the limiting constraint to the principle of inter-creditor equity. Likewise, imposing losses to Pension funds should have lasting negative consequences in countries where raising and protecting national savings is a major policy objective.

The question of inter-creditor equity also raises sequencing issues in the negotiations. The conventional sequence starts with the bilateral creditors (traditionally organized in the Paris Club), followed by the commercial creditors who take a cue from the decision of the Paris Club. The community of bilateral lenders being more diverse (with China, India, Saudi Arabia among them), it may or may not act as one group, notwithstanding the creation of the G20-sponsored Common Framework. **It appears in practice that the interests of the Paris Club members and those of the new large bilateral creditors may not always align sufficiently to allow having a unique, coordinated negotiation.**

The sequence of the different negotiations being more uncertain, the risk is that a non-cooperative game leads to a stalemate with no specific incentive to get to the finishing line. Creditor countries can wait. But debtor countries cannot.

---

[2] "How to Make Sovereign Debt Restructurings More Effective? - Better define what "comparability" means", Lazard, April 2022

[3] A possibly better alternative still, though with potentially more unexpected distribution effects, may be to make commercial debt and concessional debt comparable; in other words, strip the bilateral debt in two parts: a commercial debt and a grant element. The grant element would be safeguarded while the 'commercial' part of the concessional loan would be treated like the other commercial debt].

Note: Lazard has prepared the information herein based upon publicly available information. The information herein is provided for general informational purposes only and is not intended to be, and should not be construed as, financial, legal or other advice and Lazard shall have no duties or obligations to you in respect of the information.

To manage such risk, **it is desirable that the first group of creditors agreeing to a deal (consistent with the IMF DSA) benefit from a guarantee that subsequent deals with the other creditors will not be more favorable – and perhaps even be slightly less favorable so as to encourage early and expeditious negotiations.** In practice, some sort most favorable creditor condition would be introduced, reinforcing the principle of comparability of treatment endorsed by the Paris Club in the past.

Such a clause, if properly drafted, could also protect those creditors that have negotiated early in the process against a potential improvement of the DSA during the program period. Some automatic adjustors would be built-in and, in cases where the DSA has improved, would increase the net present value of the restructured claim up to the same net present value given to creditors who have negotiated subsequently. This would only be potentially activated during the program period and provide supplementary payments only after the program period. Once the program is terminated, such a mechanism would expire, and the debtor would be "prevented" from giving better treatment – or even an equivalent one – to creditors negotiating later on (with appropriate legal remedy to be found). Such a mechanism would create the right incentives for creditors to negotiate early on.

3. Circumventing the "financing assurances" stalemate

The third reason why debt restructuring processes stall is that the IMF process starts with a preliminary phase in which 'financing assurances' are gathered from the bilateral creditors. This precedes the proper debt negotiation – and often ends up delaying it.

A longstanding IMF principle is the non-toleration of arrears. That said, when debt is unsustainable, overindebted countries must interrupt payments. As a result, the IMF is expected to lend in support of a sound economic program, even though the country has stopped repaying (many of) its external creditors.

There are highly complex rules framing this policy, which reflect the inherently awkward position of the IMF, especially with respect to official financing. These official bilateral creditors indeed sit at the board of the IMF and can potentially object to a program supported by the staff.

In practice, the IMF tries to balance two objectives: To ensure that the indebted country engages in good-faith negotiations with its creditors, and seeks 'financing assurances' from them, otherwise the program may not be funded throughout; and to refrain from giving a veto power to a hold-out official creditor unwilling to provide such financing assurances.

Note: Lazard has prepared the information herein based upon publicly available information. The information herein is provided for general informational purposes only and is not intended to be, and should not be construed as, financial, legal or other advice and Lazard shall have no duties or obligations to you in respect of the information.

Given the current context is characterized by a low level of effective cooperation between official bilateral creditors, obtaining financing assurances is a complicated task that de facto creates a road- block to attaining a Board-endorsed IMF program – itself a pre-condition for most creditors to start negotiating.

It took seven and nine months in Suriname and Zambia respectively to obtain Board approval after the SLA had been reached, while already six months have passed since an SLA was secured for Sri Lanka and yet there is still no sight of the Board approval.

In effect, the reluctance and negligence to deliver 'specific and credible' financing assurances by some creditor countries thwarts the process before the negotiation has even started and further complicates the question of comparability of treatment.

The issue of financing assurances is stalling several ongoing debt restructuring processes. We would argue that such financing assurances from IMF members should be assumed when the IMF staff makes the case that a member country is facing an unsustainable debt justifying a decision to interrupt payments.

It is reasonable to expect that members of the IMF would a priori agree to support a debtor country in its restoring debt sustainability in so far as this is precisely the pre-condition set by the institution to provide its support. Instead, giving veto rights to creditor countries that abstain passively from responding is failing those countries in need of financial assistance – the very raison d'être of the IMF.

In practice, following a Staff Level Agreement, the IMF staff would give bilateral creditors 2 months to provide explicit financing assurances. If, at the end of the 2 months, explicit financing assurances have not been gathered from all relevant parties, another 2-month round of negotiations would open up. After that period, the obtainment of financing assurances would be presumed, and a Board meeting would be gathered where the reluctant creditor's view may be aired, and then endorsed or overruled[4].

---

[4] If no board member pro-actively objects and the program is adopted, then additional debt restructuring milestones should be added to the program conditionality, with a rendez-vous being set at the first or second review to take stock of the progress made and ensure that the debtor country is not failing its commitments under the program. If it happens that the debt agreement is delayed by the official creditors rather than the debtor, additional safeguards may then be offered to such creditor countries as part of the reviews (instead of being asked for the adoption of the program). This should create the much needed dynamics and virtuous circles that one so badly needs in current sovereign debt restructuring cases.

Note: Lazard has prepared the information herein based upon publicly available information. The information herein is provided for general informational purposes only and is not intended to be, and should not be construed as, financial, legal or other advice and Lazard shall have no duties or obligations to you in respect of the information.

Conclusion

The lives of hundreds of millions of people are tied to timely resolution of government debt restructurings. In the trade-off between speed, completeness and equity, we argue for a change in thinking. This change would allow creditors to get more in the future should a debtor country exceed its own projections, to insert clauses that incentivize creditor groups to seek early debt restructuring deals and to get around the current ‘financing assurances’ stalemate in a radical way. Time kills all deals. And the casualties are greatest when governments and countries are at stake.

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.

Contacts:

Pierre Cailleteau – pierre.cailleteau@lazard.com
Thomas Lambert – thomas.lambert@lazard.com
Jérome Alexis – jerome.alexis@lazard.com

Thomas Moatti – thomas.moatti@lazard.com