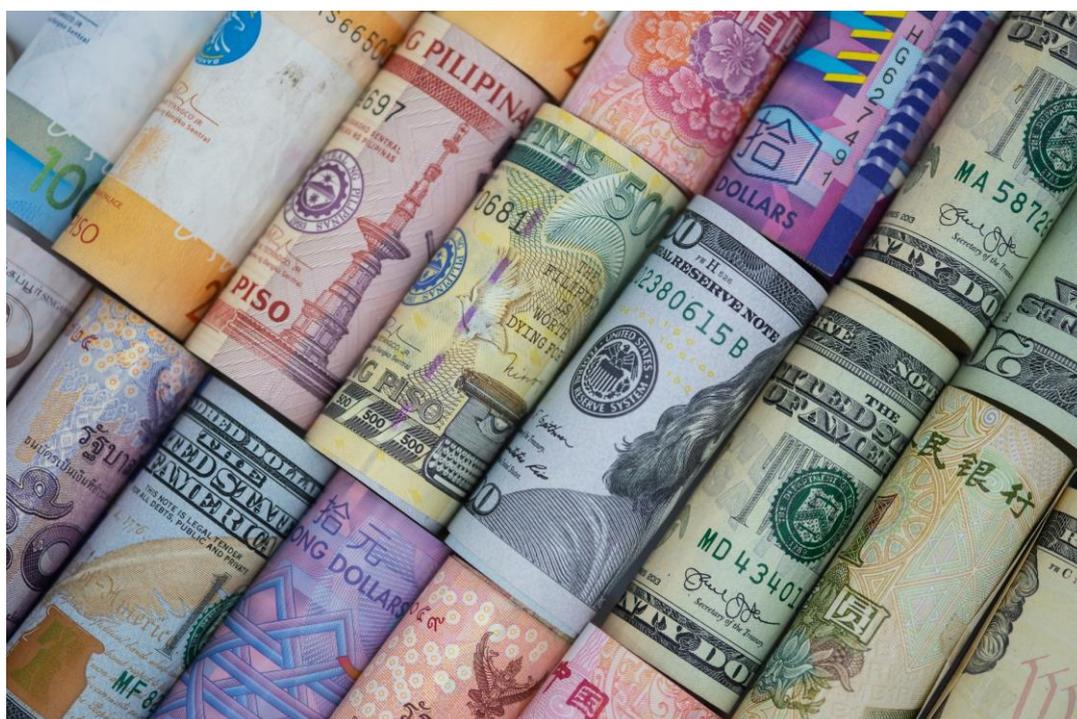




Wilton Park



Report

Emerging markets in debt distress: exploring options for debt restructuring

Wednesday 13 – Friday 15 September 2023 | WP3258

In association with:



RBC BlueBay
Asset Management

J.P.Morgan



WHITE & CASE



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The event gathered high level private and public sector representatives as well as experts from outside government in a participatory dialogue to discuss the challenges facing emerging market countries in debt distress and to identify solutions for more efficient and effective debt restructuring processes. It encompassed participants from creditor countries and companies alongside low or lower-middle income emerging market countries with high levels of debt. This report provides a summary of the key issues and policy recommendations that emerged during the conference proceedings.

Participants expressed a range of views, and the summary points that follow below, while conveying a 'sense of the conference', do not imply any consensus agreement. Some views received more support than others. Where disagreements occurred, they are noted. Section five is a summary of breakout group discussions of three key topics that the participants collectively framed for in depth examination early in the conference proceedings. This section does reflect the large weight of opinion within each of the three breakout groups, but again does not necessarily mean all participants in the groups agreed with every point. Nothing contained in the report should be read as committing any participant or their organisation to a particular course of action.

Executive Summary

Public debt stocks and debt-to-GDP ratios are elevated and are expected to grow across all economies, including emerging market and low-income countries (EMs and LICs), exacerbating debt vulnerabilities. A wave of debt crises could be looming; over 50% of Debt Service Suspension Initiative (DSSI) eligible countries are already in debt distress or at high risk of debt distress. In this context, it is vital to strengthen the effectiveness of debt crisis resolution processes and encourage pre-emptive action. At the same time, unlocking new capital flows is urgently needed to meet the pressing financial needs of EMs and LICs for social and infrastructure investment as well as for climate change adaptation and mitigation

Domestic debt relative to GDP has increased significantly. Thus, domestic debt restructurings will become more common in the future, with potentially severe implications for financial stability.

The establishment of the DSSI and, subsequently of the Common Framework (CF) under the auspices of the G20 and of the Paris Club in the wake of the COVID pandemic has represented a significant step forward, signalling the shared commitment to tackle debt sustainability issues despite the increasing diversity of bilateral lenders. Nonetheless, implementation of the CF has been slower than hoped. This can be attributed to a

number of reasons, including difficulties in coordination between creditors, as well as domestic challenges in debtor countries.

It is understood that China (which was not represented at this conference), currently the largest bilateral lender, has been voicing concerns involving various aspects of the current debt restructuring architecture. These aspects include the perceived lack of transparency of the debt sustainability assessments underpinning restructuring negotiations, the preferred creditor status of multilaterals, the definition of the restructuring perimeter and comparability of treatment vis-à-vis commercial creditors. Efforts to build and enhance multilateral cooperative solutions to address debt sustainability issues in EMs and LICs should be further promoted, even though fostering trust and collaboration between bilateral creditors is likely to require time.

Debt restructuring processes are hampered by issues of sequencing in the debt treatment provided by different groups of creditors, a perceived lack of transparency and inter-creditor equity concerns. In the view of a substantial number of participants, a particularly controversial element is the IMF's debt sustainability assessment (DSA), which conditions the restructuring envelope binding both official bilateral creditors and commercial creditors, who are required to provide financing assurances consistent with the DSA prior to the approval of IMF programmes. While some conference participants did not evince concern over the DSA process, those from the private sector in particular perceive a lack of transparency, arbitrariness, and conservativeness of DSAs, exacerbating concerns over inconsistent and unequal treatment.

These concerns could be addressed by involving commercial creditors earlier in restructuring negotiations. Furthermore, the employment of innovative financial instruments could help to bridge the gap between commercial creditors and the IMF DSA regarding expectations of the future economic prospects of borrowing countries.

Case studies of Ukraine, Zambia, Sri Lanka and Ghana each presented individual and unique challenges involved in debt restructuring efforts, collectively illustrating their considerable complexities.

The key take-aways emerging from the conference are the following:

- Despite the increasing diversity of bilateral creditors and the challenges posed by geopolitical tensions, there is scope to continue working on multilateral and cooperative solutions to debt sustainability issues and the financing gap faced by EMs and LICs, following up on the progress already made in the Common Framework.
- There is a need to enhance the voice and agency of borrowing countries throughout debt crisis resolution processes, building at the Global Sovereign Debt Roundtable (GSDR), via both initiatives to build capacity for debt management and by supporting access to financial and legal assistance.
- Pre-emptive crisis response should be encouraged, including through the establishment of regular communication channels and engagement processes with creditors.
- One of the conference breakout groups concluded that inviting the IMF to take on a more active role in obtaining financing assurances from the bilateral creditors who are its shareholders could arguably help reduce delays in the progress of debt restructuring. An alternate view felt that in practice the IMF is very active in seeking financing assurances.
- Several conference participants considered that there should not be any rigid sequencing in the treatment of different sets of financial obligations. Commercial creditors should be encouraged to act promptly and there should be a margin of flexibility in the comparability assessment to incentivise timely action.
- Intercreditor equity concerns could be tackled by enhancing transparency and information sharing regarding both the composition of the borrowing country's debt profile and the parameters underlying the formulation of the DSA.

- A significant view expressed at the conference argued that the creation of an entity to represent private creditors on an ongoing basis in debt restructuring negotiations and other debt-related matters could help ensure higher levels of transparency and trust amongst creditors, while also contributing to speedier outcomes. Moreover, it might lead to the identification of new solutions to deal with legacy debt and unlock additional sources of finance.
- The employment of innovative or re-purposed financial instruments in debt restructurings represents an opportunity to ameliorate uncertainties surrounding DSAs and to mobilise new capital flows to meet the financing needs of Ems and LICs.

Global debt dynamics and the situation of emerging market countries

Public debt stocks and debt-to-GDP ratios have been mounting over the past years across advanced as well as emerging market economies and low-income countries (Ems and LICs) and experienced a sharp increase in the wake of the COVID crisis. As of today, debt-to-GDP ratios remain elevated and are still expected to grow. Most notably, a distinguishing feature of the current situation compared to public debt surges in the past is the increase of domestic debt – both defined by governing law and by creditors’ residence – relative to GDP, including in Ems and LICs. This is reflected by the growing share of domestic debt restructurings (DDRs) in recent debt restructuring cases. Looking forward, the risk that countries in distress will have to restructure domestic debt, with potentially grave implications for financial stability, is bound to rise further.

Ems and LICs are particularly prone to debt vulnerabilities; over 50% of DSSI-eligible countries are currently in debt distress or at high risk of distress. In this context, there is a pressing need to strengthen the effectiveness of debt crisis resolution processes and encourage pre-emptive action. Compared to debt restructurings following a default, pre-emptive debt restructurings are generally faster and the economic consequences in terms of decline in growth and investment are less severe. Moreover, beyond addressing legacy debt, unlocking new financing flows is vital to address Ems extensive financing needs for social investment, infrastructure and climate change mitigation and adaptation among others.

The increasing diversity of bilateral creditors and geopolitical challenges

The landscape of bilateral creditors has significantly evolved over the past decades. While financing flows and development aid from Paris Club members to Ems and LICs have shrunk following the reduction of bilateral and multilateral debt through the Heavily Indebted Poor Countries (HIPC) initiative in 1996 and the Multilateral Debt Relief Initiative (MDRI) in 2005, non-Paris Club countries such as Saudi Arabia, India and most notably China have become increasingly important bilateral lenders. Within countries eligible for the Poverty Reduction and Growth Trust, compared the overall share of bilateral debt as a percentage of GDP has remained roughly similar since 2006, declining slightly from 38% to 33%, but the relative share of non-Paris Club countries has sharply increased from 11% to 22%.

This development has affected in relative terms the traditionally pre-eminent position of Paris Club lenders and Bretton Woods institutions. Coupled with rising geopolitical tensions, coordination and information sharing among official sector creditors have become more difficult. In the view of some participants, new bilateral lenders, and China in particular, are seen as being rather reluctant to abandon a bilateral approach to the resolution of debt sustainability issues, aggravating inter-creditor equity concerns and causing delays in the progress of debt crisis resolution processes.

Scaled up financing from IFIs and Paris Club countries could help to better address EMs’ and LICs’ financing needs, such as through infrastructure finance, loan guarantees, supply chain agreements and debt relief as well as by leveraging the IMF’s lending into official arrears policy. These kinds of initiatives could hypothetically allow debt

restructuring processes and IMF programmes to proceed despite the accumulation of arrears towards creditors insisting on strictly bilateral negotiations and debt treatments. While EMs and LICs would welcome access to such scaled up financing options from IFIs and Paris Club creditors, they also appear determined to maintain their relationships with new bilateral lenders for two major reasons.

Firstly, many EMs and LICs greatly value and do not want to jeopardise their broader relationships with new bilateral lenders. Secondly, borrowing countries are keen to continue the possibility of accessing alternative financing sources, as this increases their agency in borrowing choices and throughout debt restructuring processes.

The establishment of the DSSI and subsequently in the wake of the COVID crisis of the Common Framework (CF) under the auspices of the G20 and the Paris Club has represented an important step forward in signalling a shared commitment to tackle debt sustainability issues in eligible countries. However, progress on the implementation of debt treatments under the CF has been slow: of the four countries that applied – Zambia, Chad, Ethiopia and Ghana – an agreement has been reached only in the cases of Chad and Zambia.

Building trust between IFIs and Paris Club members on the one hand, and new bilateral lenders on the other has proved challenging, especially with regards to China, which has become the single largest bilateral creditor. Several participants highlighted China's concerns over various aspects of current debt restructuring processes. The first issue is the lack of transparency in the formation of the IMF DSA, which has been partially addressed by the recent establishment of the Global Sovereign Debt Roundtable in 2023, where the IMF has agreed to share some information at an earlier stage. This concern over transparency is shared by private sector creditors.

The second concern involves the preferred status of MDBs, which account for a significant percentage of debt service. Over the next year in DSSI eligible countries 27% of debt service is due to MDBs and 29% to Chinese lending entities. It is widely reported that in China's view, MDBs should be required, if not to provide debt relief, at least to scale up their efforts to meet the financing needs of EMs and LICs. The third controversial issue lies in uncertainties as to the definition of the restructuring perimeter, both in terms of the treatment of non-resident debt holdings and contingent obligations as well as in terms of the distinction between private sector and official sector obligations.

A step forward has been made in the context of Zambia's debt restructuring negotiations with the agreement to include a large publicly guaranteed syndicated loan owed by ZESCO, Zambia's state-owned electricity company, to China Eximbank in the perimeter of the debt restructuring and to treat Sinosure-covered bank loans as commercial. - Fourthly, various officials creditors worry about the enforcement of comparability of treatment vis-à-vis commercial creditors.

Against this background, fostering trust and collaboration among bilateral creditors is likely to require time but progress is underway, especially within the context of the Common Framework. There are strong reasons to believe that multilateral cooperative solutions to tackle debt sustainability issues and the financing needs of EMs and LICs are in the best interests of not only of these countries but also those of both Paris Club and new bilateral lenders. It is important to continue to develop and strengthen such solutions.

Transparency in debt restructuring processes and intercreditor-equity concerns

While the Common Framework now provides a potential process for restructuring the debt of 73 eligible countries, there is nonetheless no single coherent legal and institutional framework for the governance of sovereign debt crises, debt restructuring processes require separate negotiations concerning different types of financial obligations and involving different sets of creditors. In the view of many participants, this gives rise to

issues of sequencing in the debt treatment provided by different groups of creditors, lack of transparency and inter-creditor equity concerns.

Typically, the IMF plays a critical role in sovereign debt crisis resolution processes by providing emergency financial assistance to countries in distress. Debt restructurings generally take place against the backdrop of an IMF programme. Notably, the prior negotiation of an IMF financing arrangement is a pre-requisite for debt treatment under the CF.

However, the final approval of financing arrangements by the IMF's Board requires the obtaining of financing assurances from official sector creditors concerning the willingness to provide debt relief consistent with the IMF's debt sustainability assessment (DSA). While traditionally borrowing countries have been responsible for securing financing assurances, as discussed in further detail in section 5 one solution to improve efficiency of the CF restructurings to emerge from the breakout group discussions would be to shift the burden to the IMF itself. An alternate view felt, however, that the IMF is already very active in seeking financing assurances and that blockages have little to do with who is asking for them.

Given the relative flexibility of the IMF's policy of lending into private sector arrears, financing assurances from commercial creditors are not formally required. However, private sector debt treatments are still bound by the comparability of treatment principle.

Thus, the function of the IMF DSA is key, as it determines the restructuring envelope. However, commercial creditors represented at the conference criticised the process for the formulation of the DSA as lacking transparency and adequate involvement of other stakeholders, i.e., bilateral and official creditors. The commercial creditors generally perceived DSAs as unilateral, based on inconsistent and arbitrary parameters and excessively conservative. The rationale for the distinction between the DSA framework for low-income countries and that for market access countries was also called into question.

In sum, many of the private sector participants asserted that the constraints on the restructuring negotiations imposed by the IMF DSAs foster concerns of inconsistent and unequal treatment, especially among commercial creditors. As discussed further in section 5, a conference breakout group concluded that the inclusion of commercial creditors earlier in the restructuring negotiations could go a long way towards addressing concerns around transparency and allow for a speedier process, not to mention contribute to the development of a fuller set of potential alternative solutions.

One potential example in this context could include employing innovative financial instruments that enable adjusting the cash flow depending on variations in the economic indicators post-restructuring relative to the baseline scenario in the DSA. Such instruments could bridge the gap in expectations about the future between commercial creditors and the IMF DSA. However, this bridging function cannot be stretched indefinitely and adds complexity to debt negotiations.

Challenges in sovereign debt crisis resolution processes through the lens of recent case studies

Several examples of EMs currently undergoing debt restructuring or at risk of debt distress highlight the main challenges faced during restructuring negotiations as well as the difficulties in ensuring the fulfilment of EMs' financing needs.

Ukraine

The stability of the macroeconomic framework has been severely affected by the war. The current economic equilibrium is dependent on international support and domestic borrowing while the financial resources raised are entirely devoted to war expenses and the provision of essential public services, with grave consequences for debt sustainability.

Ukraine's successful reconstruction and economic stabilisation after the war – a strategic priority for NATO, the EU and other allies – will require significant financial resources.

Official and private sector support should play an essential role. In order to raise private sector finance, the issue of debt sustainability will have to be addressed, first through a restructuring of the existing debt stock. In this context, some private sector participants stressed that it would be desirable to promptly establish a broad based process of engagement with all stakeholders to ensure that information and expertise are shared effectively. The potential advantages of swift negotiations with commercial creditors are demonstrated by the standstill on payments in relation to bonded debt agreed by bondholders in 2022, thus before the start of Ukraine's current IMF programme. Incentivising private sector creditors to provide debt relief and avoiding holdout issues will require thinking about innovative solutions to raise cash flows.

For example, some suggested that the seizure of the proceeds generated by frozen Russian assets could be considered as an interim measure before a definitive legal solution for the stock of such assets is reached. Furthermore, as the need for a future debt restructuring following the end of the war can already be anticipated, Ukraine's restructuring might provide an opportunity to discuss and experiment with the employment of innovative financial instruments to help mobilise new financing flows. Some have suggested this could include debt for reconstruction swaps or future financing rights.

Zambia

Zambia's debt crisis has been long in the making. Well before the COVID shock, a public investment drive in infrastructure projects mainly financed by non-Paris Club bilateral creditors increased the vulnerability of the country's finances while market funding had dried up already in 2015. In the wake of the pandemic, Zambia obtained interim cashflow relief under the DSSI. However, the launch of a subsidy programme for the agricultural sector led to a further increase in domestic debt and arrears and partial usage of the July 2020 increase to the IMF's special drawing rights (SDRs). In September 2020, negotiations with bondholders, who had formed a committee some months earlier, for a voluntary debt standstill failed. With debt levels exceeding 140% of GDP, the government defaulted on a Eurobond coupon in November 2020 and subsequently announced a moratorium on all other debt except for debt owed to multilateral creditors.

In February 2021 Zambia applied for a comprehensive debt restructuring under the Common Framework, but the process initially stalled due to the government's unwillingness to realistically engage with creditors pending elections in the summer of 2021. Negotiations resumed after the elections, leading to a staff level agreement on an IMF programme in December 2021. The approval of the 3 year \$1.3 bn IMF programme, though, was held up due to the need to obtain financing assurances from bilateral creditors; indeed, the official creditors committee was only formed in July 2022, while financing assurances were provided shortly after.

The approval of the IMF financial assistance programme was accompanied by the publication of the DSA, determining the restructuring envelope. However, several aspects of the DSA proved controversial for some private creditors, causing further delays in the restructuring negotiations. Most significantly according to some private creditors, the DSA assumed the exclusion of non-resident holdings of domestic debt from the restructuring perimeter despite their significance (non-resident holdings amounted to \$3.2 bn out of a total external debt stock of \$20bn. Another sticking point for some private creditors concerned the assumption that Zambia's classification as having 'weak debt carrying capacity' extended to the post programme period, while alternative economic models predicted that the country's debt carrying capacity could rise to medium by the end of the programme.

The IMF ultimately revised the DSA macro framework in April 2023, which enabled overcoming the issues surrounding the exclusion of non-resident holdings of domestic securities. Moreover, additional MDB grants were included as programme financing, ameliorating China's concerns on the marginal contribution of multilaterals to the resolution of the crisis. Against this background, an agreement on official debt treatment

was finally reached, allowing the implementation of the IMF programme and paving the way for the signature of an MoU. The agreement is rather innovative, as it foresees the possibility of a subsequent adjustment of the debt treatment if economic conditions justify an upgrade of Zambia's debt carrying capacity as evaluated under the IMF/WB LIC DSA.

An agreement on the treatment of commercial debt is outstanding, and negotiations in this regard are ongoing. The bondholder committee comprises 15 global organisations, directly holding 45% of Zambia's Eurobonds. Several challenges will need to be resolved in order to reach an agreement. First, the commercial debt treatment will have to fit within the parameters of the DSA and will have to be broadly comparable to the treatment provided by bilateral creditors. Notably, the latter focused largely on duration extension and a downward adjustment of interest payments, while commercial creditors are willing to also provide principal reductions. Moreover, the agreement with commercial creditors will have to replicate the conditional treatment envisaged by bilateral creditors, allowing adjustment to the parameters of the relief provided depending on the evolution of Zambia's debt carrying capacity. To this end, objective and reliable indicators of economic performance, such as export revenues, will have to be identified.

Sri Lanka¹

Sri Lanka's ongoing debt restructuring has been prompted by a severe social, political and economic crisis. The authorities, however, have responded positively to the unfolding crisis by promptly engaging with the IMF and official creditors. This allowed them to negotiate an IMF Extended Facility programme to underpin debt restructuring and to ultimately obtain bilateral financing assurances from official creditors within a reasonable timeframe.

Nonetheless, given that Sri Lanka was not eligible for debt treatment under the Common Framework, conducting separate bilateral negotiations with official creditors has proved challenging due to creditor fragmentation and geopolitical tensions. At the end of 2022 the country's outstanding debt stock was \$41 bn, the largest share of which consisted of private sector bonded debt (32%) and the rest divided among different official creditors: 28% held by multilateral creditors, 12% by Paris Club members, 18% by China, and 4.5% by India. China, in particular, has been voicing concerns as to the preferred treatment of multilateral creditors vis-à-vis Chinese development banks. Moreover, while signalling willingness to consider debt reprofiling and coupon reduction, it has opposed principal haircuts. Although financing assurances have been obtained, separate negotiations as to the precise terms of the treatment of bilateral obligations are still ongoing.

One element of Sri Lanka's IMF programme that has been particularly challenging is the focus on total debt as opposed to external debt, and the consequent requirement to restructure domestic debt alongside external obligations. Moreover, the engineering of the domestic debt restructuring raises significant inter-creditor equity issues, as domestic banks (which held approximately 30% of the bonds) have been excluded from the restructuring due to the need to preserve financial stability.

As concerns private sector debt, which represents the biggest component of Sri Lanka's debt stock, bondholders organised swiftly and took the initiative to independently offer financing assurances to support the IMF's programme approval. A conclusive agreement on the treatment of private sector debt remains outstanding. The main challenge in this regard concerns the gap between the market's expectations about future economic prospects and those entailed in the IMF DSA, based on the Market Access Countries Debt Sustainability Framework (MAC DSF). Some have suggested that this gap could potentially be bridged through the employment of innovative financial instruments, such as fixed income instruments meeting the DSA scenario accompanied by other financial

¹ This discussion of Sri Lanka is based on the context that existed up to the conference dates of 13-15 September, and therefore do not take account of more recent developments.

instruments mobilising additional cash flows depending on the improvement in economic parameters.

Ghana

Clear indicators of debt distress in Ghana had already emerged in 2019, but crisis response was delayed due to impending elections. Following the change of government, the authorities negotiated a staff-level agreement with the IMF for an upper credit tranche programme in December 2022 and applied for debt treatment under the Common Framework. The official creditor committee was formed in May 2023 and negotiations for the restructuring of \$5.4 bn in bilateral debt are ongoing. Ghana's external debt stock also comprises \$14.6 bn of Eurobonds, which need to be restructured. Indeed, the implementation of the IMF programme depends on the restructuring of external debt totalling \$11bn.

In the meantime, in order to demonstrate their commitment to tackle debt sustainability issues, the authorities chose to restructure domestic debt, which accounted for over 20% of debt servicing costs. The domestic debt restructuring has been facilitated by the employment of regulatory coercion over the banking sector, with the central bank weighting the risk of non-restructured bonds at 100% and the risk of exchange bonds at 0%. However, the implications for financial stability could be severe; 75% of the investment of the banking sector was in government securities and the restructuring determined a loss in NPV terms of around 30% to 35%. Moreover, the central bank's exposure to domestic debt has significantly increased throughout the restructuring.

The conference's focal points

Based on extensive discussions among the participants, three topics were identified as focal points for the conference proceedings:

- How to improve the sovereign debt restructuring process, from initiation to completion;
- How to improve relationships between borrowers and lenders; and
- How to leverage innovative or repurposed financial instruments to enhance the effectiveness of debt restructurings.

The sovereign debt restructuring process, from initiation to completion

The pre-emptive phase

Notwithstanding indicators of imminent debt distress, borrowers often tend to delay approaching IFIs to request financial assistance or engaging with creditors to obtain a waiver, a bridge financing or a reprofiling of their financial obligations. This represents an impediment to the smooth resolution of temporary liquidity issues and generally results in a worsening of the crisis. Furthermore, it can aggravate the economic consequences of a debt restructuring once it becomes inevitable; compared to pre-emptive restructurings, debt restructurings following a default event take longer and can lead to a sharper decline in economic growth and investment as well as to a longer period of market exclusion.

This tendency to defer crisis response has multiple causes. Most notably, these causes include the borrower's perception of a stigma connected to the request for financial assistance from IFIs, the fear of negative market signals deriving from consultations with creditors and the political costs associated with IFIs' financial assistance programmes and debt restructurings.

In this context, the following measures could be considered further:

- The formation of neutral forums within which borrowers can seek advice and exchange experiences, such as advisory groups composed of former finance ministers or officials working in debt management offices of borrowing countries.

- A framework for regular engagement with creditors, especially private sector creditors, as a matter of best practice, building on the GSDR. The regularity of the exchanges would minimise the risk of negative market signals. Furthermore, once the indicators suggest a risk of distress it would allow creditors to formulate proposals for pre-emptive action, for example mobilising liquidity. The existence of a body representing private creditors could contribute to ongoing dialogue without the precondition of ‘urgency’ due to the situation at hand.
- Increase monitoring of the borrower’s economic situation by creditors.

The initiation phase

The initiation of a debt restructuring process depends on the borrowers. Typically, it involves borrowers’ engagement with the IMF to seek financial assistance, unless the country in distress is already in an IMF programme. Similar to the pre-emptive phase, the main challenge at this stage consists in the tendency to delay the request for financial assistance, due to perceptions of stigma and to the political costs involved. The following suggestions are advanced in this regard:

- Borrowers should consider hiring financial and legal advisers before approaching IFIs, whereas at the moment this is typically done afterwards. This would increase borrowers’ awareness of available options, including with regard to sources of financial and technical support, and enhance their agency throughout the process.
- The establishment of a regular and informal channel of communication with creditors would reduce the risk of delays.

The restructuring process

A majority of participants viewed the main challenges arising in the restructuring process to be: the sequencing and the timing of negotiations with IFIs and different sets of creditors, as well as transparency issues and inter-creditor equity concerns². In particular, bilateral creditors generally require the prior negotiation of an IMF financial assistance programme before reaching an agreement on official debt treatment. However, the IMF Board’s approval of preliminary staff level agreements requires the initial implementation of economic reforms on the side of the borrower (prior actions) as well as the obtaining of financing assurances from the official sector. The latter element was viewed by many private sector participants as a source of major delays.

All creditors, in turn, are bound by the IMF’s DSA, which determines the overall restructuring envelope. However, some creditors, especially in the private sector, feel that there is a lack of transparency and meaningful creditor involvement in the formulation of the DSA, fostering perceptions of arbitrariness and uneven treatment of different groups of creditors. Permanent Paris Club members do not tend to share this view.

The role of the different actors involved in the debt restructuring process could be improved in various ways. In the view of most private sector participants, as regards the IMF, lack of trust and delays could be addressed through:

- The IMF’s engagement in consultations with all stakeholders, including private sector creditors, throughout the formulation of the DSA. While the final decision on the DSA remains with the IMF, such consultations would allow all stakeholders to offer their views on debt sustainability, increasing the transparency of the process and alleviating inter-creditor equity concerns.
- Encouraging the IMF staff to take the lead in securing financing assurances from official creditors. Shifting this task to the IMF staff following the negotiation of a

² It should be noted that a group of participants agreed to discuss and release, as a follow up action after the conference, a proposal outlining a timeline for debt restructuring processes and a set of principles concerning the responsibilities of all stakeholders involved. The proposal will be published soon.

staff level agreement would reduce the pressure on borrowers and arguably smooth and accelerate the final approval of IMF programmes.

Regarding official creditors, challenges and delays could be ameliorated by:

- Formulating and releasing best practices, including an indicative timeline for the key steps of the process, including, the formation of the official creditor committee following the negotiation of a staff level agreement, the provision of financial assurances, and the formulation of a MoU. Creditors should be required to provide updates on the process in case of material departures from the established timeline.³
- Clarifying that there is no necessary sequencing between official debt treatments and private sector debt treatments and encouraging early action from private sector creditors, including through adequate incentives such as flexibility margins in the comparability of treatment assessment.
- Maintaining that comparability of treatment should not be evaluated based on mathematical formulas. The comparability assessment should be sufficiently flexible to incentivise early action, based on the presumption that faster restructurings preserve more value for the borrowers and all stakeholders.

Regarding the role of private sector creditors, restructuring processes could be enhanced by:

- Proactive and early coordination among different creditor groups, which might allow reaching an agreement on private sector debt treatment prior to the final approval of an IMF programme.
- Creation of an entity representing private sector creditors on an ongoing basis in debt negotiations and other debt related matters. Such a group, similar in concept to the previous London Club but adapted to the current creditor and market landscape, would provide a voice for private creditors at all stages of the debt discussions, helping to address concerns around transparency and trust, while also potentially accelerating discussions and permitting more comprehensive and sustainable solutions for debtors and creditors alike.
- The identification and proposal of innovative or re-purposed financial instruments to
 - a) manage the perceived challenges in the assumptions underlying the DSA; and
 - b) mobilize new financing flows (e.g., through contingent instruments).

The relationship between borrowers and lenders

Many participants stressed that the speed and effectiveness of debt restructuring processes could be significantly improved by building a sense of trust and shared responsibility between borrowers and creditors. This could be achieved by working on four fronts.

Borrowers' responsibilities

Borrowers can strive to develop a relationship of trust and confidence with their creditors through regular communication and the establishment of effective regulatory and institutional frameworks to deal with debt. Capacity constraints in debt management offices should be addressed as far as possible. Relatedly, greater transparency as to the composition of the debt profile would enhance creditors' confidence. One possibility in this regard would be to adopt transparency clauses, on the model of the one employed in Ecuador's 2020 restructuring, foreseeing disclosure obligations and qualifying the lack of publication of the relevant documentation as a default event. Furthermore, borrowers should aim to anticipate the resolution of debt issues, including through the establishment of appropriate internal accountability mechanisms, and promptly engage with the creditors

³ This measure has previously been suggested elsewhere but has not achieved a consensus on the part of all creditors.

concerned. Finally, debt sustainability and resilience to shocks could be improved by the adoption of clauses requiring borrowing countries to meet certain economic targets, for example predetermined debt/GDP ratios, before issuing new debt.

Creditors' responsibilities

Creditors should endeavour to share information with borrowers and assist in the development of borrowing countries' debt management capacity in various ways, including through financial contributions and pro bono activities like seconding their own personnel. IFIs could consider providing salary support for the personnel of borrowers' debt management offices in order to help build and maintain capacity. University faculties should be used to provide both research support to governments in debt management and negotiations and to provide specialised training. Training opportunities could be also offered by other organizations such as the Emerging Markets Traders Association (EMTA). Finally, to the extent feasible creditors could seek ways to engage with credit rating agencies on debt policy issues to try and mitigate the risk that credit rating actions might penalise borrowing countries and discourage them from promptly addressing vulnerabilities, as has been the case, for instance, with the DSSI.

Improve the response to external shocks

External shocks such as climate events, variations in commodity prices or shifts in the monetary policies of advanced economies can have a significant impact on the debt sustainability of emerging market economies. While climate events can be partially dealt with by contractual instruments such as disaster clauses, anticipating payment standstills or debt reprofiling at the occurrence of certain categories of events, commodity prices and spill-over effects of external monetary policy shifts are more challenging. There is a need for a broader stakeholder engagement to ensure that the burden of these shocks is shared more equitably.

Enhance the voice and agency of borrowing countries

There is the need to increase the voice of borrowers throughout debt crisis resolution processes. In this regard, there might be scope for regional organisations, particularly on the African continent, to enhance the voice and agency of member countries in global governance. Relatedly, there should be greater accountability of IFIs, and especially the IMF, vis-à-vis borrowing countries.

Enhance the voice and agency of private creditors

There was a recognition of the need to increase the voice of private creditors throughout debt crisis resolution processes with an aim to improve both the process and outcomes. Additionally, providing private creditors a seat at the table can also contribute to the creation of innovative approaches to unlocking availability of much needed new private sector capital to borrowing countries. This can be achieved through the creation of a new entity, specifically designed to represent private lenders in ongoing monitoring, proactive dialogue as well as in restructuring processes.

The potential of innovative financial instruments in the context of debt restructurings

Innovative or re-purposed financial instruments represent an opportunity to address some of the obstacles impeding sovereign debt restructurings. The main factors that determine the suitability of different instruments to be employed in the sovereign debt restructuring context pertain to the ease with which they can be priced, the existence of an identifiable investor base given institutional constraints affecting certain investors, and the legal or technical challenges connected to the engineering of the various instruments. Achieving a degree of standardisation would support the diffusion of new instruments in the market.

Financial instruments dealing with legacy debt

There are a series of financial instruments that might help deal with legacy debt and smooth the restructuring process by counterbalancing the uncertainties inherent in evaluations of debt sustainability and future economic prospects. They can help bridge questions on burden sharing and increase creditors' willingness to reduce the debt burden. These are:

- **State-contingent bonds:** The coupon on this kind of bond increases or decreases depending on economic variables, such as GDP or government revenue (a more timely indicator). This can compensate for the uncertainty inherent in debt sustainability assessments and, at the same time, supports long term sustainability from the borrowers' perspective as interest payments decrease in case of deterioration of the economic parameters. While these instruments are widely investible, there are challenges pertaining to the timeliness and measurement of the underlying economic variables.
- **Future financing rights:** Forgone payments in debt restructurings are compensated through vouchers permitting the purchase of future issuance at a discount. These instruments have the advantage of offsetting the uncertainty inherent in debt sustainability assessments by partially compensating creditors once the borrower regains market access while, simultaneously, incentivising the purchase of the new issuance and thus addressing borrowers' financing needs. However, they might not be widely investible due to institutional constraints.
- **GDP (or commodity-linked) warrants:** The pay out of these financial instruments is dependent on an increase in GDP (or key commodity prices) relatively to predetermined levels. Similarly to state-contingent bonds and future financing rights, this sort of instrument redresses uncertainties in the assumptions underlying debt sustainability assessments and addresses inter-creditor equity concerns around taking losses in a restructuring process when future economic scenarios may allow repayment. While the publicity of the documentation concerning GDP enhances transparency, challenges remain as to the timeliness and the measurement of the relevant variables, which may be easier with commodity-linked warrants where prices are timelier.
- **Bonds collateralized or asset backed with state assets:** The suitability of these financial arrangements in the context of sovereign debt restructurings may be more limited in application. While they allow, analogously to the instruments mentioned above, to address uncertainties and inter-creditor equity concerns and unlock new resources for future debt service, the availability of adequate state assets or cashflows and the enforceability of the arrangements might prove challenging.

Financial instruments addressing financing needs

A series of financial instruments could be employed in debt crisis resolution processes to support new financing flows. These are:

- **Bonds with partial risk free collateral or guarantees (e.g., the partial guarantees provided by the World Bank, or the partial collateralisation of Brady-bonds by US treasury bonds):** These arrangements involve respectively the provision of a partial guarantee by a risk free entity or the borrower's purchase of a zero-coupon long dated risk free bond as partial collateral. They support the provision of new finance and are widely investible. However, potential challenges relate to the need to find a pool of capital to provide the partial collateral, or to size constraints of entities acting as guarantors, such as multilateral development banks.
- **Fully guaranteed bonds (e.g., US aid bonds):** These instruments support the provision of new finance and have the potential to produce scale up effects. However, guarantors can be subject to budget or credit constraints. Furthermore, there is the need to find an investor base outside of Emerging Markets funds that is willing to buy what will be lower yielding debt.

Other financial arrangements might be considered, even though their suitability is more questionable:

- **Debtor-in-possession financing:** This arrangement consists of the issuance of short-term senior debt to cover the restructuring period. However, there are issues of overlap with lender of last resort functions currently covered by IFIs and ensuring the seniority of claims is likely to encounter legal challenges in the sovereign debt context.
- **State-contingent step-down bonds or payment holidays:** Coupon payments on these bonds decrease or are suspended if a macroeconomic variable deteriorates compared to a predetermined threshold or if there is a standstill payment to official sector creditors. Similar arrangements have the advantage of ensuring the long term sustainability of the debt profile by providing relief when debt distress is anticipated. If linked with payment holidays offered by the official sector, they also help in addressing inter-creditor equity concerns. However, challenges remain as regards the timeliness and appropriate measurement of underlying variables, meaning the cashflow relief may not come when needed.
- **State contingent bonds on other key performance indicators (e.g., climate variables):** The coupon payments on these bonds increase or decrease depending on the achievement of certain goals (key performance indicators or KPIs), such as benchmarks concerning climate change mitigation or adaptation policies. While this sort of instrument allows in principle to foster financing flows by unlocking ESG capital as well as to support the achievement of non-economic policy objectives, the measurement of the relevant variables is likely to be challenging, which will make pricing these more difficult.
- **Use of proceeds from ESG bonds:** The proceeds of these bonds are earmarked for the achievement of ESG goals. While they serve analogous purposes as KPIs contingent bonds, helping to mobilise ESG finance, the concrete enforcement of use of proceeds clauses encounters difficulties.
- **Tax free bonds for developed market retail investors:** These arrangements involve the provision of tax incentives to retail investors in the developed markets to buy debt issued by emerging market countries. While such instruments would support the provision of new finance, it is unclear whether there is adequate demand.

To conclude, the development of new financial instruments or the re-use and standardisation of existing instruments should be pursued to allow faster debt restructurings, address legacy debt and secure new financing. At the same time, a balance needs to be struck between ensuring that economic growth following a restructuring is able both to benefit borrowers and to enable the compensation of creditors.

Conclusions and future outlook

This Wilton Park conference, with its special format and thoughtful selection of participants, has provided a unique opportunity for informal and positive engagement among various stakeholders, leading to constructive discussions and valuable insights. Indeed, several private sector participants have expressed the potential goal of drawing inspiration from this experience to envisage a permanent forum for discussion and information exchange on sovereign debt issues, a 'Wilton Park for sovereign debt'.

In sum, the key take aways emerging from the event are:

- Despite the increasing diversity of bilateral creditors and the challenges posed by geopolitical tensions, there is scope to continue working on multilateral and cooperative solutions to debt sustainability issues and the financing gap faced by EMs and LICs, continuing along the lines of the progress made in the Common Framework.

- There is a need to enhance the voice and agency of borrowing countries throughout debt crisis resolution processes, by assisting capacity building as regards debt management and favouring access to financial and legal assistance.
- Pre-emptive crisis response should be encouraged, including through the establishment of regular communication channels and engagement processes with creditors.
- Delays in the progress of debt restructurings could be addressed by inviting the IMF to take on a more active role, in particular with regards to the obtaining of financing assurances from bilateral creditors, in other words its shareholders (an alternate view felt that in practice the IMF is very active in seeking financing assurances).
- It should be emphasised that there is no rigid sequencing in the treatment of different sets of financial obligations. Commercial creditors should be encouraged to act promptly and there should be a margin of flexibility in the comparability assessment to incentivise timely action.
- Intercreditor-equity concerns could be tackled by enhancing transparency and information sharing regarding both the composition of the debt profile and the parameters underlying the formulation of the DSA.
- The creation of an entity to represent private creditors on an ongoing basis in debt restructuring negotiations and other debt related matters would help ensure higher levels of transparency and trust amongst creditors, while also contributing to speedier outcomes. Moreover, it might lead to the identification of new solutions to deal with legacy debt and unlock additional sources of finance.
- The employment of innovative or repurposed financial instruments in debt restructurings represents an opportunity to ameliorate uncertainties surrounding DSAs and to mobilise new capital flows to meet the financing needs of EMs and LICs.

It should be noted that the above recommendations constitute improvements to the existing multi-layered and fragmented framework for the governance of sovereign debt crises. However, there remains scope for further reflections and discussions aimed at rethinking more radically the current system, in particular as concerns the possible establishment and design of a unitary legal and institutional framework for the management of sovereign bankruptcies, building on the idea of the IMF's Statutory Sovereign Debt Restructuring Mechanism idea in the early 2000s.

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