Sovereign Domestic Debt Restructuring: Handle with Care

SUERF

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Outline

- Motivation
  - Takeaways from Sovereign Debt Restructuring Experiences during 1980-2020
  - Considerations For Restructuring Sovereign Domestic Debt
  - Mitigating Spillovers
- Conclusion
Why Focus on Sovereign Domestic Debt Restructuring (DDR) now?

*DDRs are likely to be part of future sovereign debt restructurings in EMDEs*

- Share of domestic in total public debt in EMDEs: 33% → 46% (2000 → 2020)

COVID 19 crisis:
- Total public debt in EMDEs
  ~ 40% (2013) → ~ 60% (2021) of GDP
- Projected to stay elevated over the MT
- Sovereign-financial sector linkages 🔺
- Share of EMDEs at risk of public debt distress 🔺
Why Are DDRs Different?

- **Definition**: Domestic debt = Public debt governed by domestic law (correlated with domestic debt based on residency and currency)

- **Sovereign decides** whether to restructure
  - IMF advises members should stay current with obligations
  - Paper provides economic and legal considerations

- **DDRs are different** from sovereign external debt restructurings (EDR)
  - Spillovers: *Domestic institutions* bear the brunt of financial losses
  - Impact exacerbated by *fiscal consolidation* and *stress* in financial system
  - May mitigate *loss of external market access*
  - Sovereigns enjoy “*local law*” advantage
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Sovereign Debt Restructuring Episodes: 1980-2020

*Domestic sovereign debt restructurings have become relatively more frequent over time*

**Sovereign Debt Restructuring Events, 1980-2020**

(by type)

<table>
<thead>
<tr>
<th>Type</th>
<th>Description</th>
<th>Count</th>
</tr>
</thead>
<tbody>
<tr>
<td>EDR</td>
<td>standalone external debt restructuring</td>
<td>71</td>
</tr>
<tr>
<td>IFR</td>
<td>high inflation/financial repression</td>
<td>43</td>
</tr>
<tr>
<td>EDR/IFR</td>
<td>EDR accompanied by high inflation/financial repression</td>
<td>37</td>
</tr>
<tr>
<td>DDR</td>
<td>standalone domestic debt restructuring</td>
<td>36</td>
</tr>
<tr>
<td>EDR/DDR</td>
<td>EDR accompanied by DDR</td>
<td>27</td>
</tr>
</tbody>
</table>

**Sovereign Debt Restructuring Events, 1980-2020**

(by sub-period, by type)

- **1980-1989**
- **1990-1999**
- **2000-2009**
- **2010-2020**

Notes: Dataset includes ~ 90 countries (EMDEs, Cyprus and Greece), which had at least one episode of restructuring of sovereign domestic or external debt to private creditors during 1980-2020.
Severity of Shocks & Scale of the Debt Problem

Greater economic and/or financial stress tend to lead to larger scale debt restructurings

Public Debt Restructuring Events Preceded or Accompanied by Banking Crises, 1980–2020
(number of events in percent of total number of events for each type of DR)

Real GDP Growth Rates Around Public Debt Restructuring Events, 1980–2020
(average by type of DR event, yoy percent)

Restructured Debt, 1998–2020
(average by type of DR event, percent of total public debt)

Note: A debt restructuring (DR) event is preceded or accompanied by a crisis if a crisis occurs at time t, t-1, t-2, or t-3 where t is the first year of a DR event.
Post-Restructuring Macro-Financial Outcomes

Post-restructuring outcomes tend to be worse when both domestic and external financing channels become impaired

Real GDP (cumulative change, percent)

Domestic Credit/GDP (cumulative change, percentage points)

Gross Capital Inflows/GDP (cumulative change, percentage points)

Note: $t$ is the first year of a debt restructuring (DR) event
Opting for Domestic Debt Restructuring

Structural characteristics affect the debt restructuring choices

External public debt to private creditors
(percent of public debt, median & interquartile range, by type of DR)

Domestic bank credit to private sector
(percent of GDP, median and interquartile range by type of DR)

Key Considerations

- Severity of economic & financial stress
- Scale of the debt problem
- Sovereign debt structure & investor base
- Depth & resilience of the domestic financial system
- External market access & reputational costs
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**Decision Making Framework for a DDR**

**An Illustrative Decision Framework**

**Step 1:** Determine the overall debt relief target (DRT)* to restore public debt sustainability.

**Step 2:** Identify the perimeter (i.e. instrument type) and categories of creditors holding “restructurable debt”

**Step 3:** For each category of creditors determine the potential contribution to DRT

<table>
<thead>
<tr>
<th>Types of creditors</th>
<th>DOMESTIC LAW PUBLIC DEBT</th>
<th>FOREIGN LAW PUBLIC DEBT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic Banks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic NBFIs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public Sector Entities</td>
<td>Estimate the net contribution to DRT as the difference between gross debt relief and fiscal costs associated with the restructuring (e.g. recapitalization, subsidies, etc.)</td>
<td></td>
</tr>
<tr>
<td>Other Domestic Non-Financial Institutions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign private creditors</td>
<td>Determine potential contribution to DRT in negotiations while taking into account litigation risk</td>
<td></td>
</tr>
</tbody>
</table>
### Decision Making Framework for a DDR (continued)

**Step 4:** Assess the economic costs associated with obtaining relief

<table>
<thead>
<tr>
<th>Types of creditors</th>
<th>DOMESTIC LAW PUBLIC DEBT</th>
<th>FOREIGN LAW PUBLIC DEBT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic Banks</td>
<td>Assess potential costs of mitigating:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1. macro-financial implications</td>
<td></td>
</tr>
<tr>
<td>Domestic NBFIs</td>
<td>2. adverse effects on market access</td>
<td></td>
</tr>
<tr>
<td>Public Sector Entities</td>
<td>3. creditor coordination and holdout risks</td>
<td></td>
</tr>
<tr>
<td>Other Domestic Non-Financial Institutions</td>
<td>4. political economy considerations</td>
<td></td>
</tr>
<tr>
<td>Foreign private creditors</td>
<td>Assess potential costs of:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1. capital outflows, BoP and FX pressures</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2. macro-financial implications</td>
<td></td>
</tr>
<tr>
<td></td>
<td>3. adverse reputational effects on market access</td>
<td></td>
</tr>
<tr>
<td></td>
<td>4. creditor holdouts and collective action issues(/options)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>5. spillovers from unresolved debt</td>
<td></td>
</tr>
</tbody>
</table>

**Step 5:** Central Bank: Ensure the normal operation, including of the payments system and assess the need for any immediate (or future) recapitalization(s) needs.

**Step 6:** Determine which categories of debt to restructure in order to minimize overall costs while also achieving the DRT and supporting broader macroeconomic reforms.
#### Decision on the Perimeter of DDR has several Dimensions

<table>
<thead>
<tr>
<th>Type of Borrowers</th>
<th>Type of Claims</th>
<th>Type of Creditors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central government</td>
<td><em>Currency</em>: Foreign vs Local</td>
<td><em>Residency</em>: Resident vs non-resident</td>
</tr>
<tr>
<td>State-owned enterprises</td>
<td><em>Marketability</em>: Marketable vs Non-marketable debt</td>
<td><em>Relationship with Borrower</em>: Private creditor vs public sector</td>
</tr>
<tr>
<td>Sub-national government</td>
<td><em>Placement type</em>: Wholesale vs retail</td>
<td><em>Institutions</em>: Banks vs other non-bank institutions (pension funds)</td>
</tr>
<tr>
<td>Government guarantees</td>
<td><em>Securities type</em>: Bonds vs T-bills</td>
<td><em>Entity</em>: Entities vs individuals</td>
</tr>
</tbody>
</table>

→ **Casting net wide** supports participation by lowering relief sought from each group
Design and Execution of the DDR

- Decision to proceed with a DDR → need a design and execution strategy
- **Fair and transparent process** helps to encourage participation and reduces likelihood of litigation
- **Design instruments** to mitigate vulnerabilities
- **Use incentives** for higher participation rates (“carrots” and “sticks”)
- **A credible reform plan** aimed at restoring macroeconomic and financial stability as well as conditions for strong growth is essential for securing creditors’ buy-in
- **Communication:** Explain details of situation and the exchange to all stakeholders, and understand the creditors and their limitations
Legal Toolkit for DDRs

• “Local law advantages” – Legislative or executive action to change debt obligations
  
  • **Statutory Majority Restructuring Mechanism** - Adoption of law to introduce a majority restructuring mechanism to facilitate a DDR (e.g., Greece, 2012; and Barbados, 2018)
  
  • **Directly changing terms of debt obligations** – Taking legislative or executive actions to directly change the sovereign’s debt payment obligations (e.g., Argentina, 2019)

• Evaluate potentially adverse consequences of “local law advantage”
  
  • Risks of retroactive legal measures
  
  • Litigation risk (e.g., Greece’s 2012 debt restructuring)
Domestic CACs – Potential benefits and issues

• The Fund’s focus on the inclusion of CACs in international sovereign bonds

• Possible introduction of CACs into domestic bonds:
  • Market acceptability - Need to consult with creditors about the benefits and design of potential domestic CACs
  • Legal feasibility - Implications of introducing domestic CACs for the sovereign borrower’s legal and regulatory framework and bond issuance practice
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Financial Stability Implications

- **Risks of financial instability are higher** in DDR as the financial system will already be in a vulnerable condition.

- **Direct impact** on the balance sheet (capital) and earnings potential:
  - Reduced haircut through reprofiling can attenuate financial system stress.

- **Indirect impact** on the financial system can also be damaging:
  - Interlinkages with other financial institutions.
  - Collateral, margin calls and disruptions in interbank liquidity.
  - Loss of confidence → deposit runs and fire sale of assets.
  - Capital flight → exchange rate pressure.
Safeguarding financial stability

- **Stress testing** is an integral part to assess the impact on the financial system
  - To inform on crisis management and resolution framework

- **Early recognition and addressing of income losses and recapitalization needs** helps mitigate impact on real economy over time

- **Crisis management and bank resolution framework**
  - Financial safety nets need to be supported by contingency planning
  - Address gaps in early intervention and coordination arrangements
  - Financial sector stability fund → liquidity and capital support

- **Temporary capital flow management** measures in line with IMF view
  - reduce risk of disorderly market conditions until macro-financial policies become effective

- **Central bank’s** balance sheet may need to be strengthened
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• **Key consideration**: net—rather than gross—benefit after fiscal & economic costs

• **Perimeter**: wide scope to support participation

• **Process**:
  • Fair & transparent; communication
  • Economic reform plan; carrots & sticks
  • Be mindful of creditor preferences within sustainability objective
  • Use local law advantage only when other options exhausted; domestic CACs?

• **Mitigation**:
  • Safeguard financial stability: loss recognition; liquidity & potentially solvency support
  • Temporary capital flow measures & other CB intervention for market functioning
  • Tailored policies for CB and non-bank financial institutions