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?

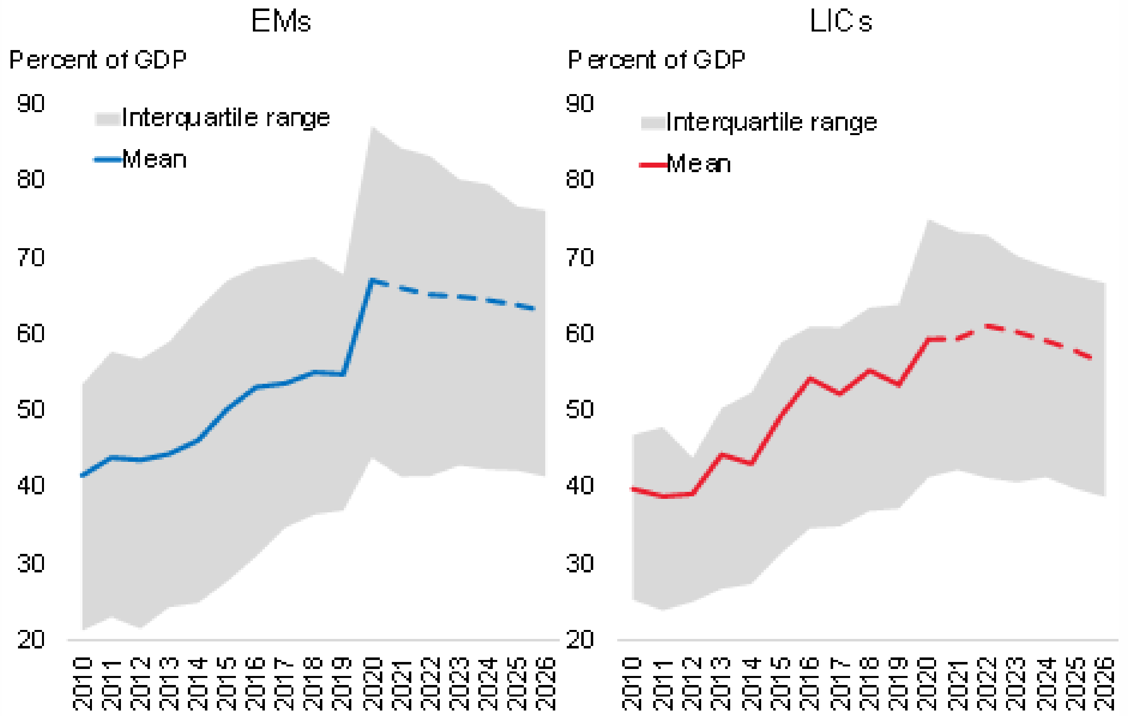
DDRs are likely to be part of future sovereign debt restructurings in EMDEs

- **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** ⬆

Public Debt in EMDEs
(in percent of GDP)



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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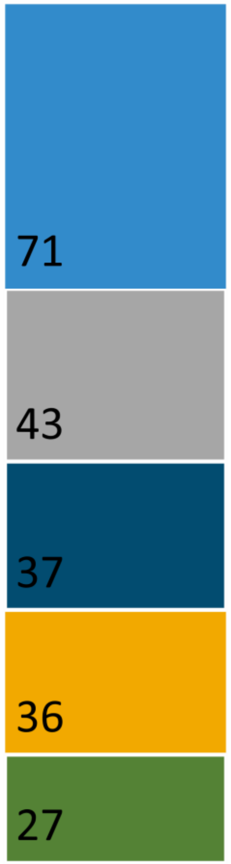
Sovereign Debt Restructuring Episodes: 1980-2020

Domestic sovereign debt restructurings have become relatively more frequent over time

Sovereign Debt Restructuring Events, 1980-2020
(by type)



EDR = standalone external debt restructuring

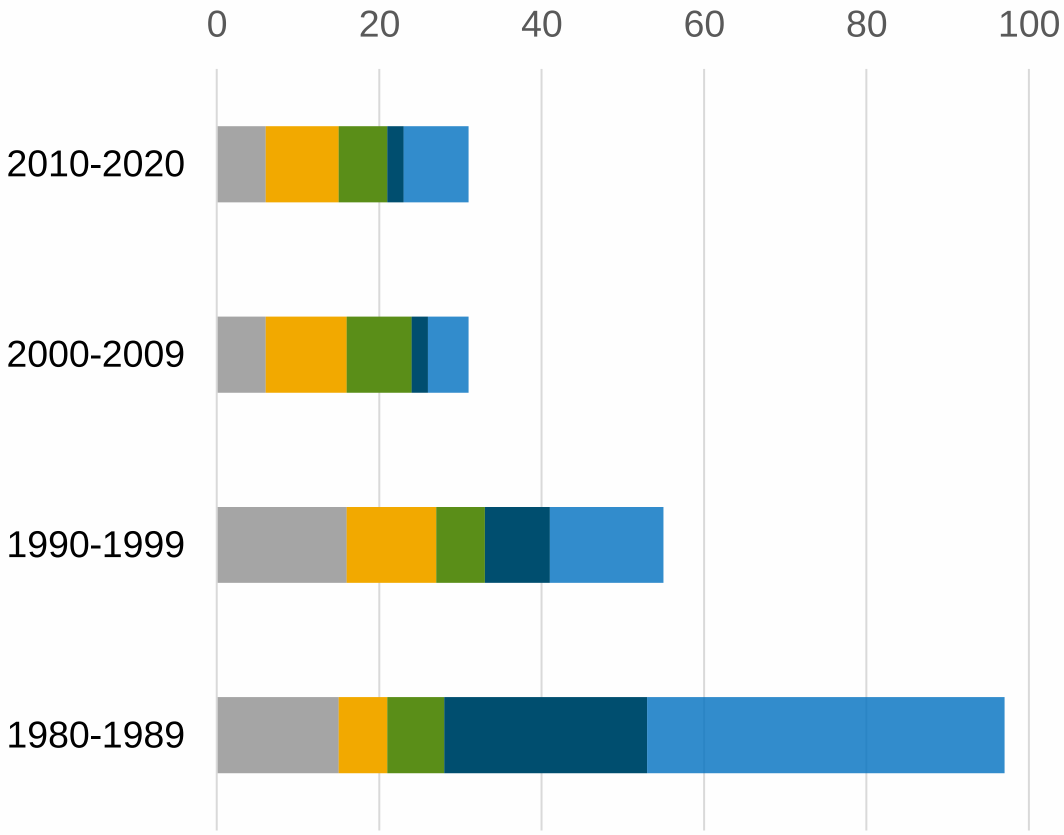
IFR = high inflation/financial repression

EDR/IFR = EDR accompanied by high inflation/financial repression

DDR = standalone domestic debt restructuring

EDR/DDR = EDR accompanied by DDR

Sovereign Debt Restructuring Events, 1980-2020
(by sub-period, by type)

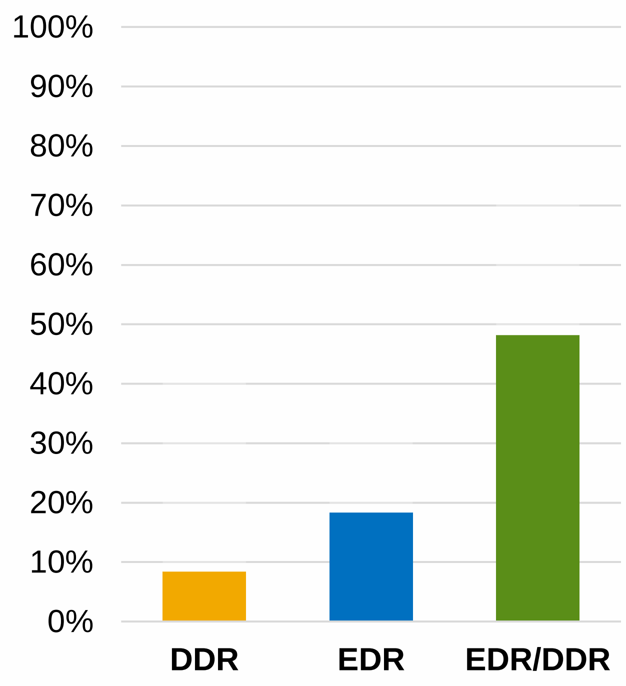


Notes: Dataset includes ~ 90 countries (EMDEs, Cyprus and Greece), which had at least one episode of restructuring of sovereign domestic or external debt to private creditors during 1980-2020

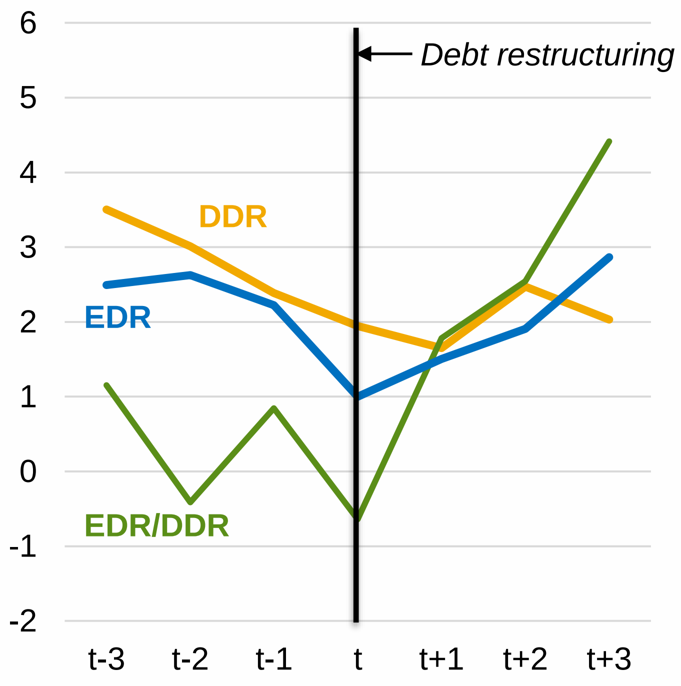
Severity of Shocks & Scale of the Debt Problem

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

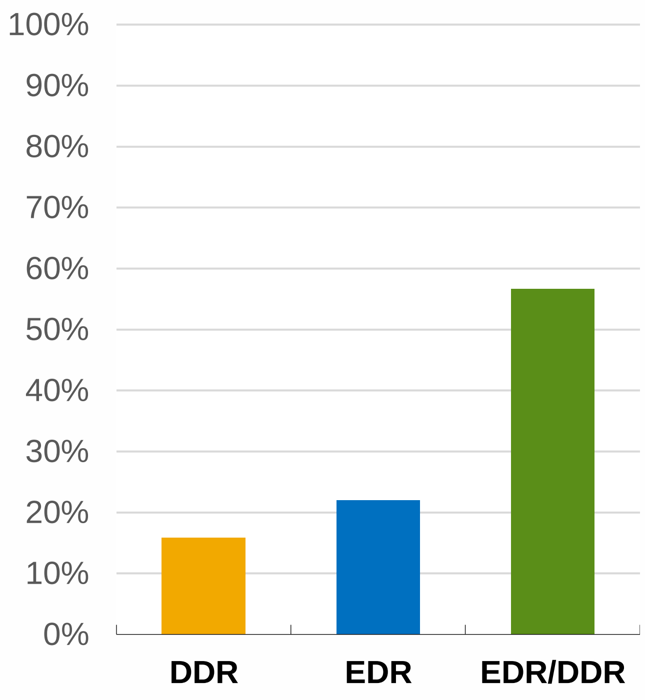
Public Debt Restructuring Events Preceded or Accompanied by Banking Crises, 1980–2020
(number of events in percent of total number of events for each type of DR)



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



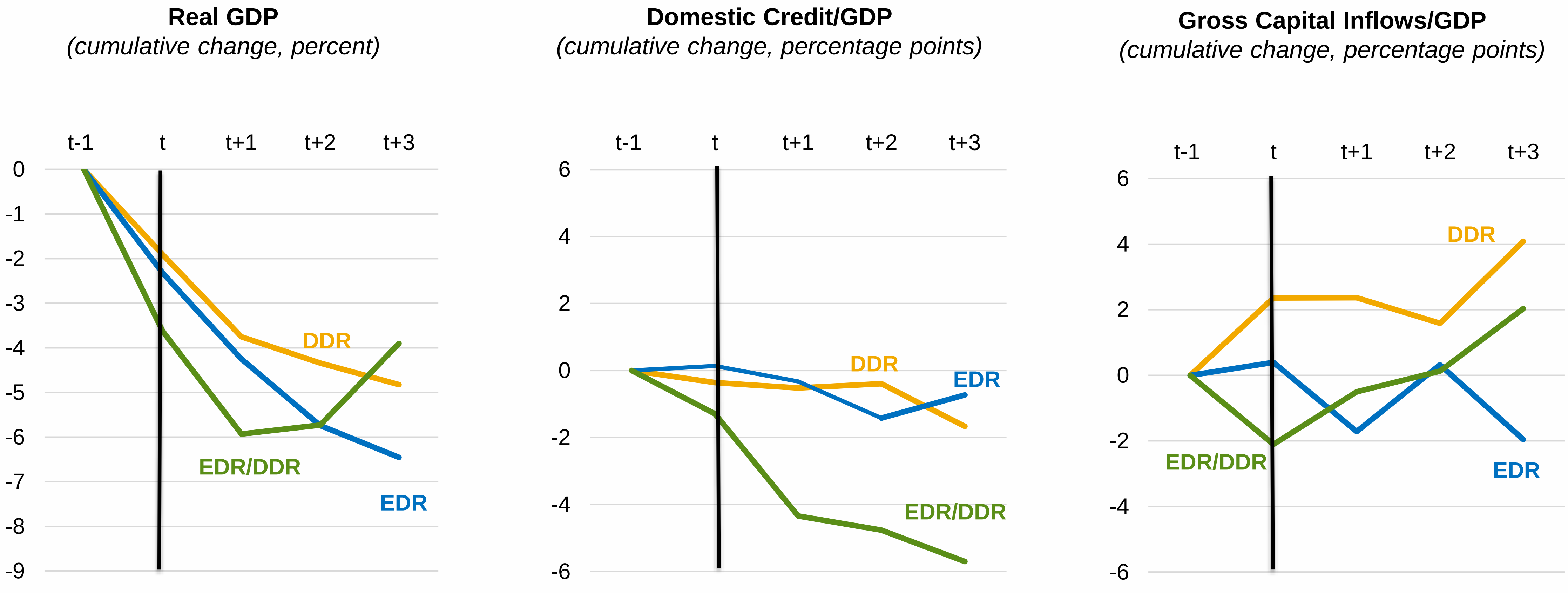
Restructured Debt, 1998–2020
(average by type of DR event, percent of total public debt)



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

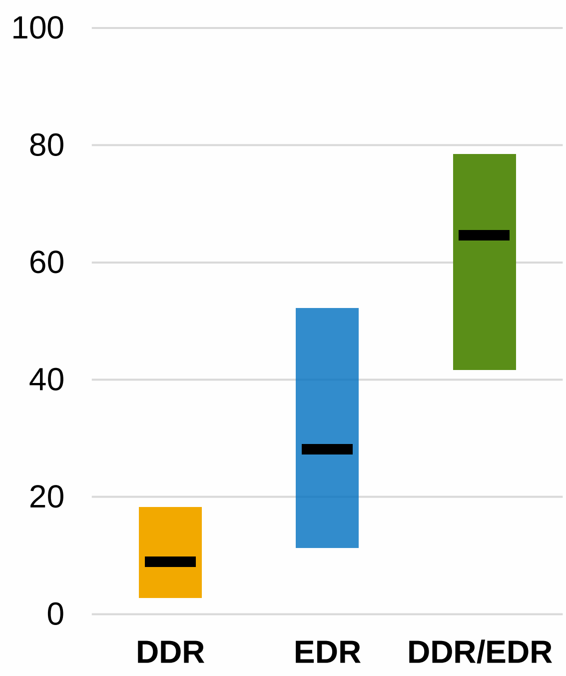


Note: t is the first year of a debt restructuring (DR) event

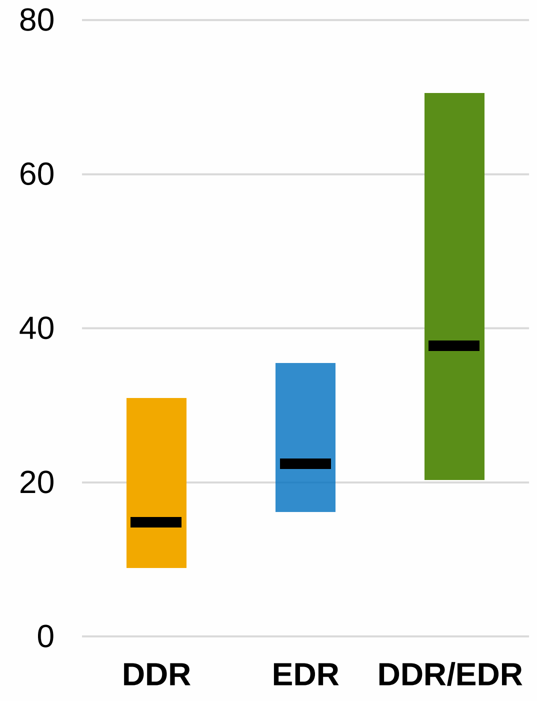
Opting for Domestic Debt Restructuring

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

	Types of Debt	
Types of creditors	**DOMESTIC LAW PUBLIC DEBT**	**FOREIGN LAW PUBLIC DEBT**
Domestic Banks	*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.)*	
Domestic NBFIs		
Public Sector Entities		
Other Domestic Non-Financial Institutions		
Foreign private creditors	*Determine potential contribution to DRT in negotiations while taking into account litigation risk*	

Decision Making Framework for a DDR (continued)

Step 4: Assess the economic costs associated with obtaining relief

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

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

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

➔ ***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