



24-4 Restructuring Sovereign Debt The Need for a Coordinated Framework

Sean Hagan and Brad Setser

May 2024

When a sovereign's debt is unsustainable, all stakeholders—the sovereign, its official creditors, and most private creditors—share an interest in a restructuring that quickly restores sustainability. Notwithstanding this general alignment of interests, the current restructuring process is subject to delay and unpredictability. Concerns regarding intercreditor equity are a key factor, and these concerns have been exacerbated by the “sequential” nature of the restructuring process, where official creditors are generally expected to commit to debt relief terms before private creditors. To speed up the restructuring process, this Policy Brief proposes that the restructuring of official claims and private claims proceed in a parallel yet coordinated manner. To address intercreditor equity concerns, a new contingency mechanism would be available to allow simultaneous decision making: Before one creditor group decides to accept an offer, these creditors would know what everyone else is being offered. Such a mechanism would not be mandatory—there may be circumstances where one group is prepared to move before the others. Such a “Coordinated Framework” will require greater information sharing, consistent with the types of transparency reforms that have been advanced by the International Monetary Fund (IMF).

Sean Hagan, nonresident senior fellow at the Peterson Institute for International Economics, is former general counsel for the International Monetary Fund, professor at Georgetown Law and Sciences Po, and advisor to Rothschild & Co.

Brad Setser is the Whitney Shepardson Senior Fellow at the Council on Foreign Relations.

INTRODUCTION

One of the distinguishing features of the sovereign debt architecture is that it is constructed entirely on the basis of accepted norms and practices. Unlike corporate or bank reorganization, there is no public law that guides the process. And perhaps not surprisingly, the evolution of these norms and practices has been shaped by events, with each sovereign debt crisis revealing weaknesses that, in turn, catalyze reform.

It is fair to say that, for many years, the central preoccupation of policymakers has been reform directed at the resolution of collective action problems among private creditors. Coordination problems across private creditors had grown in importance with the shift from bank loans to bonds, the growing diversity of creditor interests, and the success of holdout and litigation strategies in countries such as Peru and Argentina. It is also fair to say that the reforms introduced

to date have been relatively successful in reducing the leverage of potentially disruptive private creditors: whether it be through a strengthening of IMF policies, including its policy of lending into arrears, or through the introduction of increasingly robust collective action clauses in sovereign bond contracts.¹

The establishment of the Common Framework in late 2020 was a recognition of the emergence of a different type of collective action problem—one involving official bilateral creditors.² As in the case with private creditors, the perceived need for reform was driven by changes in composition: The Paris Club restructuring process could not continue to be the anchor of coordination given that many of the largest official bilateral creditors—including China—were either not members of the Paris Club or were unwilling to subscribe to its principles. Hence the importance of the Common Framework: All G20 countries (including China) agreed, at least in theory, to a set of principles (many of which are derived from the Paris Club process) and also agreed to join with traditional creditors in a single official creditors committee for the restructuring of the debt of low-income countries. The goal was the establishment of a new collective framework that would reduce delays and avoid concerns that the concessions made by one set of creditors only served to increase payments to others.

When assessed against its own stated objectives—let alone the expectations at the time of its creation—the Common Framework has fallen short. Although some progress has been made, the system is still subject to delays, with the recent case of Zambia (discussed below) illustrating the unpredictability of the system. Moreover, a delay in reaching a restructuring agreement with official creditors can also delay IMF support as IMF policies make it more difficult for the IMF to lend in the absence of an agreement among official creditors. While recent reforms by the IMF are designed to increase flexibility in this regard, it is still too early to assess the extent to which this flexibility will, in fact, be exercised.³

In light of these shortcomings, this Policy Brief makes the case for reforms that would coordinate the restructuring of both private and official claims and allow for the simultaneity of decisions by both groups. The existing “sequential” system—where a sovereign’s engagement with private creditors takes place after an agreement has been reached with the official sector—is contributing to the paralysis that continues to delay and weaken the system, largely because of intercreditor equity considerations. Under a Coordinated Framework, the decisions of official creditors and private creditors would initially proceed in parallel, and a contingency mechanism (described below) would allow for decisions to be taken simultaneously. Such a process will require more up-front transparency and sharing of information regarding creditor claims and the proposed treatment of such claims.

1 IMF, “The IMF’s Policies on Sovereign Arrears,” May 18, 2022, <https://www.imf.org/en/About/FAQ/imf-policies-on-sovereign-arrears#Section%201>; IMF, “Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring,” September 2, 2014, <https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Strengthening-the-Contractual-Framework-to-Address-Collective-Action-Problems-in-Sovereign-PP4911>.

2 IMF, “Questions and Answers on Sovereign Debt Issues,” April 8, 2021, <https://www.imf.org/en/About/FAQ/sovereign-debt#Section%205>.

3 IMF, “IMF Executive Board Endorses Reforms to Promote the IMF’s Capacity to Support Countries Undertaking Debt Restructurings,” April 16, 2024, <https://www.imf.org/en/News/Articles/2024/04/16/pr24119-imf-exec-board-endorses-refm-imf-cap-countries-debt-restruct>.

As will be discussed, simultaneous decision making does not mean that all creditors will receive the same treatment. But simultaneity does give creditors the assurance of knowing, before they accept an offer, what is being offered to other creditors. In other words, it requires transparency and procedural fairness—both of which are lacking in the current system. It is recognized that simultaneity may not be required in all circumstances. There may be cases where one group is willing to move before the others, or where the claims of one group of creditors are too small to impact the overall restructuring in a material way. But in those cases where the equitable allocation of debt relief is central to the overall restructuring, a mechanism would be available that would ensure that all major creditors moved together, with visibility into the restructuring terms offered to other groups.

The “rules” (i.e., norms) that would govern the Coordinated Framework could be further developed by a suitably expanded Global Sovereign Debt Roundtable (GSDR) and endorsed by the G20. The proposal builds on the ideas set forth in our previous PIIE blog.⁴

THE EMERGENCE OF THE SEQUENTIAL APPROACH

The existing sequential approach has its roots in the 1980s debt crisis. At the outset of the crisis, when a rescheduling of the claims to both the banks and official bilateral creditors became a key element of the crisis response, both groups of creditors needed assurances—somewhat understandably—that any debt relief would be accompanied by an economic adjustment program that would enhance the capacity of the sovereign to repay its debt. Accordingly, the existence of an IMF-supported program became a condition for both groups of creditors. But the combination of external and internal adjustment together with IMF financing was generally insufficient to allow the debtor to cover all external debt payments. As a result, the IMF believed that it needed assurances (generally referred to as “financing assurances”) that the debt relief needed to fully finance the program would in fact materialize.

In light of the above needs, conventions were established during the early stage of the debt crisis that resulted in a parallel—but not sequential—process. With respect to official bilateral creditors, the IMF received assurances from the Paris Club (the forum where debt relief from official creditors was negotiated) that an “Agreed Minute” was expected to be reached in the near future that would set forth an agreement in principle regarding the terms of debt relief that would be provided to the country. On that basis, the IMF would formally approve the program and provide financial support, a decision that would, in turn, trigger the finalization and signing of the Agreed Minute. With respect to the private creditors, the IMF would receive assurances from a “critical mass” of the relevant commercial banks regarding their willingness to provide the necessary debt relief.⁵

4 See Sean Hagan, “Towards an Integrated Framework to Restructure Sovereign Debt,” RealTime Economics blog, Peterson Institute for International Economics, November 16, 2023, <https://www.piie.com/blogs/realtime-economics/towards-integrated-framework-restructure-sovereign-debt>.

5 IMF, *Sovereign Debt Restructuring—Recent Developments and Implications for the Fund’s Legal and Policy Framework*, April 26, 2013, <https://www.imf.org/external/np/pp/eng/2013/042613.pdf>.

As the 1980s debt crisis evolved, however, this approach broke down—at least with respect to private creditors. Two factors contributed to the unwillingness of the commercial banks to provide the IMF with the necessary financing assurances in a timely manner. First, over time, the banks had been able to build up reserves that enabled them to absorb the potential losses that would arise from nonpayment. Consequently, they were less susceptible to the pressure from the official sector to maintain their exposure, either through providing new money or debt relief. Second, commercial banks became more resistant when it became increasingly clear that the relief needed by the countries in question required debt reduction, not just rescheduling.⁶

Faced with this challenge and the risk of delay, the IMF adopted a policy that effectively gave rise to the sequential approach. The policy in question—which was not without risk and controversy when it was adopted in 1989—enabled the IMF to approve a program in the absence of assurances from commercial banks that they were prepared to fill the program’s financing gaps. While the hope was that the banks and the sovereign debtor would eventually reach an agreement consistent with the financing parameters of the program, the IMF was prepared to continue to provide support even if no such agreement was reached and, in turn, was prepared to tolerate the accumulation of arrears to the banks. Importantly, however, this policy of “lending into arrears” did not apply to official bilateral creditors. Agreement in principle with these creditors continued to be a condition of IMF financing.

Because of this policy—and at least in those cases where there are significant official claims—the restructuring of official claims has generally taken place at the outset of the program whereas those of private creditors have been restructured at a later date.⁷

THE SYSTEM UNDER STRESS

As a result of the change in the composition of official creditors, the assumptions underpinning the sequential approach have become more tenuous. Over the past 20 years, the financing provided by large emerging economies like China, India, and the Gulf Cooperation Council countries now exceed the financing provided by traditional Paris Club creditors. This has complicated the restructuring process. Work by the IMF has shown that debt relief from these creditors has resulted in the process being far more unpredictable and subject to delays, making the well-established and comfortable relationship between the IMF and the Paris Club less relevant.⁸ Consequently, the establishment of the Common Framework by the G20 in late 2020 was considered a breakthrough at that time

6 Julianne Ams, Tamon Asonuma, Wolfgang Bergthaler, Chanda M. DeLong, Nouria El Mehdi, Mark J. Flanagan, Sean Hagan, Yan Liu, Charlotte J. Lundgren, Martin Mühleisen, Alex Pienkowski, Gustavo Pinto, and Eric Rober, “Chapter 1: The 1980s Debt Crisis,” in *Prevention and Resolution of Sovereign Debt Crises* (Washington: International Monetary Fund, 2018), <https://www.elibrary.imf.org/view/book/9781484371329/ch001.xml>.

7 In many cases in the late 1990s, official bilateral creditors did not have significant exposure, and crisis resolution hinged entirely on the restructuring of claims held by private creditors.

8 IMF, *Reforming the Fund’s Policies on the Non-tolerance of Arrears to Official Creditors*, IMF Policy Paper, October 15, 2015, <https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Reforming-the-Fund-s-Policy-on-Non-Tolerance-of-Arrears-to-Official-Creditors-PP5005>.

precisely because it involved non-Paris Club creditors committing to the type of restructuring norms that had effectively been developed in the Paris Club.

As was recently recognized by the official community itself, however, the restructuring process continues to be undermined by delays and unpredictability.⁹ Most notably, the inclusion of nontraditional creditors in the process and the expectation of credible financing assurances involving “stock” treatment that provided relief on the overall amount of debt (calculated in net present value [NPV] terms) has led to long delays between agreement with the IMF staff on a policy program and final approval of IMF financial support. While Zambia’s restructuring is likely to conclude soon, it will come after nearly four years of default. As is further discussed below, such long delays are costly to the country for a number of reasons—not least because the legal claims of certain creditors continue to accrue at the often-high contractual interest rate. These delays are not limited to the restructuring of the debt of the low-income countries that are covered by the Common Framework. Frontier economies that fall under the IMF’s new market access debt sustainability framework have also experienced lengthy delays: The IMF did not lend to Sri Lanka, which had exhausted its reserves, for a year after its default on its bonded debt and Chinese policy loans because of difficulties securing financing assurances.¹⁰ The restructuring of Sri Lanka’s official claims occurred through two separate and competitive processes, and, at the time of publication of this Policy Brief, the bondholders and Sri Lanka have still not agreed on terms after two years of default.¹¹

While these problems may have several causes, intercreditor equity concerns are clearly a significant factor. To a degree, some delays simply represent “growing pains,” as new creditors—particularly China—struggled to normalize the types of restructuring expectations that Paris Club creditors have lived with for decades. Our view, however, is that there are more fundamental problems at work here. Uncoordinated—and, on occasion secret—rescheduling agreements reached with one set of official creditors have raised significant concerns among other official creditors about intercreditor equity. At the same time, nontraditional creditors such as China are concerned about the preferential treatment given to private creditors, who were, for example, exempted from the Debt Service Suspension Initiative.¹² Moreover, the increased diversity of creditor claims has been exacerbated by geopolitical tensions that add to a lack of trust.

In theory, this problem is addressed in the Common Framework, which incorporates the comparability of treatment principle, a central feature of

9 Hugo Dixon, “Sovereign Debt Workouts Need Knocking into Shape,” Reuters, February 5, 2024, <https://www.reuters.com/breakingviews/sovereign-debt-workouts-need-knocking-into-shape-2024-02-05/>; IMF, *Global Sovereign Debt Roundtable—2nd Cochairs Progress Report*, April 17, 2024, <https://documents1.worldbank.org/curated/en/099447504172428653/pdf/IDU1c260c33e17deb141bd1ac351aa1a252dbc4c.pdf>.

10 Brad Setser and Theo Maret, “Is the IMF Setting Sri Lanka Up for a Second Car Crash?” *Financial Times*, September 5, 2023, <https://www.ft.com/content/34f53d81-3cd9-4105-97e5-4fc40133162f>.

11 Benjamin Parkin and Mahendra Ratnaweera, “Sri Lanka Reaches Preliminary Debt Restructuring Deal with China’s Exim Bank,” *Financial Times*, October 12, 2023, <https://www.ft.com/content/b1f6f3fa-13cd-43c6-a95a-aff1d629d478>.

12 IMF, “Debt Service Suspension Initiative,” March 10, 2022, <https://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative>.

the Paris Club framework. Under the principle of comparability of treatment, a sovereign debtor that benefits from debt relief from the official creditors committee under the Common Framework (or from the Paris Club creditors in non-Common Framework cases) commits that it will not provide better treatment to other creditors, whether private or public. This is designed to give official creditors some comfort that a reliance on a sequential approach—where (as noted above) official creditors move first and private creditors follow—will not result in an overall restructuring that disproportionately burdens official creditors. Importantly, the comparability of treatment principle only runs in one direction: It does not constitute a commitment by the debtor that it will not treat official creditors better than private creditors.

Questions have arisen as to whether, in fact, the principle has been rigorously enforced. One academic study found that, on average, the debt relief provided by official creditors is higher than that provided by private creditors.¹³ This study has been challenged, and other studies—including one conducted by the IMF in 2015—have concluded that official creditors, in fact, do better than private creditors.¹⁴ Irrespective of the outcomes, in the absence of the type of legal framework that exists in the corporate context (where seniority among different types of creditors is established by law), the relative treatment of different groups of claims in the sovereign context is a contested one, further exacerbating uncertainty.¹⁵

ZAMBIA: A CASE STUDY

The recent case of Zambia highlights the extent to which the sequential approach and heightened concerns regarding intercreditor equity can exacerbate delays and unpredictability.

Zambia, of course, was always going to be a particularly difficult case. Zambia's GDP data in 2021 were unreliable, placing an undue burden on indicators of external debt relative to exports. There was also uncertainty around how much overall debt relief Zambia needed, as well as some surprise among creditors that, under the IMF/World Bank Debt Sustainability Framework for Low-Income Countries (LIC/DSF), Zambia's debt-carrying capacity was classified as "weak," which implied the need for more significant debt relief than expected.¹⁶ (Under the LIC/DSF, there is a large, discontinuous jump between the debt relief creditors must provide depending on whether a country is classified

13 Matthias Schlegl, Christoph Trebesch, and Mark L. J. Wright, *The Seniority Structure of Senior Debt*, NBER Working Paper No. 25793, May 2019, <https://www.nber.org/papers/w25793> (accessed May 2, 2024).

14 IMF, *Reforming the Fund's Policy on Non-toleration of Arrears to Official Creditors*, IMF Policy Paper, October 2015, <https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Reforming-the-Fund-s-Policy-on-Non-Toleration-of-Arrears-to-Official-Creditors-PP5005>.

15 Anna Gelpern, "Sovereign Debt: Now What?" *Yale Journal of International Law* 41, no. 2 (2016): 46-95.

16 IMF, *Zambia: Second Review under the Arrangement under the Extended Credit Facility, Requests for a Waiver of Nonobservance of a Quantitative Performance Criterion, Modifications of the Monetary Policy Consultation Clause and of Quantitative Performance Criteria, and Financing Assurances Review—Press Release; Staff Report; and Statement by the Executive Director for Zambia*, IMF Country Report No. 2023/439, December 20, 2023, <https://www.imf.org/en/Publications/CR/Issues/2023/12/20/Zambia-Second-Review-Under-the-Arrangement-Under-the-Extended-Credit-Facility-Requests-for-542876>.

as having a “medium” rather than “weak” debt-carrying capacity).¹⁷ In addition, foreign holdings of local currency bonds increased rapidly after Zambia’s external default, and the exclusion of these nonresident holdings from the broader restructuring increased the burden of those creditors inside the perimeter. Finally, there was uncertainty as to whether the loans of China’s commercial banks that had been guaranteed by its export credit guarantee agency (Sinosure) would be included in the official restructuring.¹⁸ Zambia thus raised nearly all of the difficult issues poised in a restructuring in a context where the scale of China’s claims made it central to both the official and the commercial restructuring.

Although there were a number of factors at play, the sequential approach nonetheless further complicated reaching agreement. As is the norm, official creditors moved first, albeit reluctantly and after considerable delay. Some official creditors (including China) had pushed back against the scale of the haircut implied by the “weak” classification of Zambia under the LIC/DSF, discussed above. China’s concerns were only increased as it became clear that the bondholders were seeking restructuring terms that increased payments if Zambia’s debt carrying capacity was upgraded. Accordingly, securing agreement with the official creditors committee—where China had a majority of the claims—significantly delayed the required adoption of a contingent repayment structure, which ensured upside adjustment in the event that Zambia was eventually classified as “medium” under the LIC/DSF.¹⁹

Even though the adoption of a “contingent” structure in the official restructuring eased acceptance of a similar feature in the bond restructuring, securing agreement with the bondholders under the sequential approach proved difficult. Zambia’s initial agreement with its bondholder committee was rejected by both the IMF and the official creditors committee. A modestly revised proposal was accepted by the IMF but then rejected by the official creditors committee. The official creditors committee noted—not without reason—that the bondholders proposal delivered large up-front cash to the bondholders, while providing similar levels of NPV relief to the official sector deal. The official sector had expected and informally conveyed to the bondholders that they expected additional NPV relief in return for the favorable distribution of debt service during the program period. For their part, the bondholders noted—again not unfairly—that the official creditors committee could not provide information regarding the level of additional NPV relief that was needed to secure the approval of the official creditors committee. These bondholders also privately expressed concerns that the Export-Import Bank of China was holding up the final deal not to protect its own interests but rather to protect the interest of China’s commercial banks.²⁰

17 IMF, “IMF-World Bank Debt Sustainability Framework for Low-Income Countries,” February 2023, <https://www.imf.org/en/About/Factsheets/Sheets/2023/imf-world-bank-debt-sustainability-framework-for-low-income-countries>.

18 Brad W. Setser, “The State of Sovereign Debt Restructuring after the Meetings in Marrakech,” Follow the Money blog, Council on Foreign Relations, November 1, 2023, <https://www.cfr.org/blog/state-sovereign-debt-restructuring-after-meetings-marrakech>.

19 IMF, *Global Sovereign Debt Roundtable—Cochairs Progress Report*, October 12, 2023, <https://www.imf.org/en/News/Articles/2023/10/12/pr23348-global-sovereign-debt-roundtable-cochairs-progress-report>.

20 Tom Hancock, Matthew Hill, and Ramsey Al-Rikabi, “China Is Dampening Zambia’s Efforts to Come Out of Default,” Bloomberg, December 20, 2023, <https://www.bloomberg.com/news/articles/2023-12-20/china-snarls-zambia-debt-deal-after-mix-up-on-bondholder-losses?embedded-checkout=true>.

After all of these iterations, a revised (third) agreement was eventually reached with private sector bondholders, which resulted in additional NPV debt relief in return for additional cash payments in 2026 and 2027. The lapse of time was considerable: While the official creditors had reached an agreement in June 2023, the final bondholders agreement was not secured until March 2024, and as of June 2024, the actual restructuring had yet to be completed.²¹ And, somewhat ironically, the final agreement would, according to the preliminary GDP data in IMF's latest debt sustainability analysis, leave Zambia with external and public debt-to-GDP levels that put it at high risk of debt distress if the contingent features contained in the agreement with both China and the private sector are triggered.²²

There are limits to what can be achieved through reforms to the restructuring process alone when there are fundamental differences among the country's major creditors. But the current process nonetheless introduced delays in the private restructuring, as decisions about the nature of comparability that were clearly needed from the start were deferred until the end of the process, and ambiguity about the content of those requirements created confusion and delay. (It is also not helpful when the IMF and the official creditors committee render different verdicts on a proposed bond restructuring).

THE RATIONALE AND DESIGN OF A COORDINATED FRAMEWORK

In contemplating the need for—and direction of—reform, it is important to underscore the extent to which the delay and unpredictability of the existing system undermine the interests of the sovereign debtor. A protracted debt restructuring deepens economic scarring in many respects. The unresolved restructuring can impede foreign direct investment as well as weigh on domestic confidence. It delays the creation of a record of paying restructured claims and, accordingly, extends the time period needed for return to standard international market access. More narrowly, interest payments continue to accrue at their contracted rate, and—depending on how the restructuring targets are defined—this can add to the country's ultimate debt burden. Finally, to the extent that these delays also result in a delay in the approval of an IMF-supported program, it also translates into delays in economic reform.

Although the very recent reforms to the IMF's policies regarding arrears to official creditors are designed to provide the IMF with greater flexibility with respect to the provision of support, it remains to be seen how much flexibility will be introduced as a matter of practice. The IMF has historically been reluctant to lend in the face of objections from its largest shareholders, particularly in cases where the country with the most exposure is also unwilling to provide clear assurances. And even in those cases where countries implement reforms without IMF financing, the absence of any visible financial support from the official sector

21 Mukuni Zunduna, "Zambia Reaches Agreement with Official Creditors on Debt Treatment under the G20 Common Framework," Ministry of Finance and National Planning, June 22, 2023, <https://www.mofnp.gov.zm/?p=7444>; Agence France Presse, "Zambia Reaches Key Debt Agreement with Its Private Creditors," Barron's, March 25, 2024, <https://www.barrons.com/news/zambia-reaches-key-debt-agreement-with-its-private-creditors-22e3ffb4>.

22 Brad W. Setser, "The IMF Needs to Focus on Setting Good Targets for External Debt Sustainability," Follow the Money blog, Council on Foreign Relations, February 22, 2024, <https://www.cfr.org/blog/imf-needs-focus-setting-good-targets-external-debt-sustainability>.

undermines domestic political support for reform and, therefore, its durability. Of course, delays are all the more troubling when the end result is a restructuring agreement that fails to provide a clear path back to sustainability.

As a means of addressing existing delays and unpredictability, we propose a shift from a sequential to a parallel process, with the option of simultaneous decision making. As a threshold matter, and as discussed further below, this would require adequate information sharing among official and private creditors. Separate committees—one or more consisting of official creditors, one consisting of private bondholders, and, where applicable, one consisting of bank creditors—would continue to operate under their respective rules and norms.²³ However, the negotiations would proceed in parallel and, prior to accepting an offer from a sovereign, each committee would have adequate information as to what is being offered to the other. Moreover—and critically—a mechanism would be available that would enable—but not always require—a decision to accept an offer by one committee to be made contingent on the acceptance by the others.

The adoption of such an approach does not mean that private creditors and official creditors receive the same offer. Indeed, experience demonstrates that official and private creditors have different preferences. As a general matter, official bilateral creditors have an aversion to reducing the face value of their claims. For these creditors, NPV relief is provided by accepting a low coupon (below 5 percent) for an extended period. Private creditors, by contrast, are often willing to give up a portion of the par value of their claims to secure more up-front payments. As the market discount rate is typically higher than 5 percent, private creditors seek to secure as large a share of near-term cash flows as is possible. Notwithstanding these general preferences, there are important wrinkles. For example, Chinese official creditors have been keen to secure up-front payment in non-Common Framework cases.²⁴ Also, in the case of Zambia, China pushed for the introduction of the contingent instrument.

In our view, these offsetting imperatives can provide the basis for negotiations among the various creditor groups, therefore obviating the need to establish ex ante rules for the allocation of relief among different types of creditors. As a means of providing some comfort to creditors who move first under the sequential approach, a considerable amount of energy has been invested (without success) in reaching a consensus among official and private creditors as to the criteria to be used (and the weight to be given to each criterion) for purposes of measuring comparability of treatment. For example, the current Paris Club process looks at changes in nominal debt service over the IMF program period; the level of debt reduction in NPV terms, including the discount rate to be used; and the extension of duration of treated claims.²⁵ With

23 In cases outside the Common Framework, there may also be multiple committees of official creditors.

24 See, for example, Facundo Robles, “China’s Role in Latin America, Santa Claus or Debt Collector?,” Weekly Asado blog, Wilson Center, September 15, 2023, <https://www.wilsoncenter.org/blog-post/chinas-role-latin-america-santa-claus-or-debt-collector#:~:text=Beginning%20in%202020%2C%20China%20changed,of%20Ecuador’s%20total%20external%20debt>.

25 One of the authors of this Policy Brief (Setser) has proposed a simplified methodology that clarifies the calculation of comparability by focusing on the available cash flow during the program period and the level of overall debt relief (in NPV terms) needed while dropping the third criteria. See “Zambia’s comparability conundrum,” *Financial Times*, January 3, 2024, <https://www.ft.com/content/75f25f8d-5b70-48e1-9f23-83e1b74f16ee>.

the application of a contingency mechanism—where approval of the offer by one group is made contingent on the acceptance of the offer made to the other group—the metric for assessing comparability of treatment would effectively be negotiated up front, in the specific context of each case. Unlike in the sequential approach, there is no need for an ex ante formula, policing, or the application of a clawback mechanism. When decisions are taken simultaneously, fairness is, in effect, self-enforcing.

The above approach is only feasible if there is adequate information sharing, both with respect to the debt sustainability analysis (DSA) targets (including the macroeconomic assumptions underpinning these targets) and the proposed treatment of different creditors. Under IMF policy, both sets of information should now be the norm, at least in theory. With respect to information relating to the DSA, a recent guidance note issued by staff clarifies that private creditors should receive this information at an early stage of the process, and no later than when an IMF staff-level agreement is reached.²⁶ As noted by IMF staff, this will require the signing of nondisclosure agreements among creditors (thereby restricting their ability to trade or, alternatively, limiting the disclosure of this information to the legal and financial advisers of the relevant creditors committee.

The IMF recently revised its policy to require—as a condition for its assistance—that the information sharing standards that apply under its lending into arrears policy be applied in all restructuring cases. This standard requires that the sovereign provide to all creditors “a comprehensive picture of the outstanding debt stock and its terms, and the proposed treatment of all claims on the sovereign, including those of official bilateral creditors; the perimeter of claims subject to the envisaged debt restructuring; and the elaboration of the basis on which the debt restructuring would restore medium term debt sustainability, bearing in mind that not all categories of claims may need to be restructured.”²⁷ Notwithstanding this standard, however, the official sector has acknowledged that there needs to be improvements to the exchange of information across creditor groups.²⁸

Importantly, the proposed approach will only reduce delays if the interests of all groups of creditors are sufficiently aligned with respect to the need for an orderly and rapid process. Clearly, improvements in the restructuring process will not lead to rapid agreement if creditors prefer protracted default and nonpayment over restructuring terms consistent with the IMF’s debt target. Fundamental differences in interest cannot be solved through procedural improvements. Yet there is scope for optimism.

As noted earlier, Paris Club creditors have an established track record of rapidly agreeing to terms that are consistent with the parameters of an IMF-

26 IMF, *Staff Guidance Note on Information Sharing in the Context of Sovereign Debt Restructurings*, IMF Policy Paper No. 2023/027, June 2023, <https://www.imf.org/en/Publications/Policy-Papers/Issues/2023/06/23/Staff-Guidance-Note-on-Information-Sharing-in-The-Context-of-Sovereign-Debt-Restructurings-535203>.

27 IMF, *Reviews of the Fund’s Sovereign Arrears Policies and Perimeter*, IMF Policy Paper No. 2022/023, May 23, 2022 <https://www.imf.org/en/Publications/Policy-Papers/Issues/2022/05/18/Reviews-of-the-Fund-s-Sovereign-ARREARS-Policies-and-Perimeter-517997>.

28 IMF, *Global Sovereign Debt Roundtable—2nd Cochairs Progress Report*, April 17, 2024, <https://documents1.worldbank.org/curated/en/099447504172428653/pdf/IDU1c260c33e17deb141bd1ac351aa1a252dbc4c.pdf>.

supported program. To the extent that non-Paris Club creditors are hesitant to move until they have clarity on the terms to be offered to private creditors, the simultaneous decision making process described above should address those concerns.

Once a restructuring process has been initiated, most private creditors generally have an interest in completing the restructuring quickly and in a manner that clearly restores sustainability. Even when a restructuring involves a reduction in the principal amount, it generally is preferable—in terms of the recovery value reflected in the secondary market price—for the endgame negotiations to be pulled forward. A protracted process will often result in a further depreciation of the secondary market value of the original instrument, particularly when the delay contributes to greater economic dislocation in the country in question. Moreover, a restructuring that significantly compromises sustainability can itself adversely affect secondary market values of the restructured bonds: The fall in the market value of the bonds that emerged from Argentina’s 2020 restructuring upon completion of the restructuring is illustrative.²⁹

Of course, there will always be some private creditors whose business model is to profit from delays and dysfunction. Fortunately, their leverage has been reduced by the IMF’s lending into arrears policy and the development of robust collective action clauses.

How would the proposed approach have helped in the case of Zambia? It would have provided all creditors with more information up front and allowed each creditor group to know quickly the terms Zambia intended to offer other creditor groups. Official creditors would have been able to object to the proposed distribution of up-front cash to private creditors in the context of restructuring terms that offered similar NPV relief. Private bondholders would have known if the NPV relief in any official restructuring was insufficient on its own to meet the program targets in the absence of additional NPV relief (and more up-front cash) from commercial creditors. Both the official creditors committee and the bondholders would have benefited from information about the intended treatment of the commercial banks, which in this case were primarily the China Development Bank and the main Chinese state commercial banks.

As noted earlier, reforms to the process would not have been a panacea. In Zambia’s case, China’s Export-Import Bank was the largest single creditor, and China’s other state banks (considered commercial claims in the end) had as much exposure as the commercial bondholders. No definitive restructuring thus was possible until Chinese creditors—both official and private—accepted the need for a “stock” restructuring rather than a rescheduling that only deferred payments until the end of the program period. In the case of Zambia, underlying disagreements about the debt-carrying capacity calculation and IMF DSA baseline targets would have remained—along with difficulties incorporating nonresident holdings of local currency/local law debt into a set of debt restructuring targets that focus on external debt. But a better process would have pulled forward the discussion of more fundamental disagreements: The

29 Pablo Guidotti, “Argentina on the Brink, Again,” Official Monetary and Financial Institutions Forum commentary, October 7, 2020, <https://www.omfif.org/2020/10/argentina-on-the-brink-again/>.

negotiation between the official creditors committee and the bondholders over NPV reduction and up-front cash that look place in late 2023 and early 2024 would, for example, have been possible in 2022.

Somewhat encouragingly, there are clear indications that the official sector recognizes the value of this type of reform. The recently issued Progress Report of the GSDR recognizes that reducing delays in the process may require a shift to a parallel approach. Specifically:

“Importantly, the steps described above do not necessarily lead to a sequential process, with official bilateral creditors moving first and private creditors second. In particular, nothing precludes both groups to advance their negotiations in parallel. The GSDR discussion underlined that, should this be the preference of the debtor, such parallel negotiations should be supported as this would strengthen the chance for a swift and efficient resolution.”³⁰

While this represents a very important and welcome development, the modalities for implementing a parallel process need to be developed. In particular:

First, while it is true that, as a formal matter, the choice of the restructuring strategy—sequential or parallel—is one for the debtor to make, the reality is that the official sector plays an outsized role in shaping this strategy. For example, and as noted in the first section of this Policy Brief, the shift from a parallel approach to a sequential approach that occurred in the latter part of the 1980s debt crisis was driven by changes in IMF policy.

Second, and perhaps most importantly, if the objective is to truly accelerate the process by addressing intercreditor equity concerns, a parallel approach should be supplemented by the availability of a contingency mechanism that, as noted earlier, ensures that the effectiveness of the sovereign’s offer to one committee is made contingent on the separate offer being accepted by the other committee. This synchronicity is the most effective way of giving all creditors the assurance as to how the burden of debt relief is being allocated.

Of course, this contingency mechanism may not be used in every circumstance. For example, if private creditors are unwilling to negotiate within the parameters of the IMF debt targets (and the macroeconomic assumptions that underpin these targets), the framework should allow official creditors to move forward without them. More generally, official creditors would more likely opt to use the contingency mechanism—which guarantees simultaneous decision making—in those cases where, because of intercreditor equity issues, they judge that clarity on the treatment of different creditor groups is essential to agreement. Conversely—and turning the existing practice on its head—there may be cases where private creditors are willing to conclude a deal before official creditors are ready even if that risks creating space to provide official creditors with a better offer. More generally, and provided that private creditors receive key information in a timely manner, the priority they give to speed may actually create an incentive for official creditors to accelerate their own process.

30 IMF, *Global Sovereign Debt Roundtable—2nd Coauthors Progress Report*, April 17, 2024, <https://documents1.worldbank.org/curated/en/099447504172428653/pdf/IDU1c260c33e17deb141bd1ac351aa1a252dbc4c.pdf>.

In these sequential cases, the method to be used for assessing intercreditor equity should be kept simple. For example, one approach would assess whether there is a proportional distribution of available near-term cash flow (in foreign exchange) and long-term NPV relief relative to the value of each group of creditors' claims at the start of an IMF program. In these cases, the existence of a legally enforceable clawback provision would be an appropriate means of ensuring that both sustainability and equity are preserved.³¹

CONCLUSION

As noted at the outset of this Policy Brief, the framework that guides the sovereign debt restructuring process is not supported by public law (i.e., a treaty), but rather by norms and practices. While this feature has some drawbacks (e.g., no clear binding rules on creditor seniority), it has one significant advantage: The system can be adjusted relatively quickly to address new challenges and, if these adjustments are not sufficient, adjusted again. In light of experience, an adjustment is long overdue. To address the intercreditor equity issues that have arisen as a result of the changing composition of creditors, the time has come to shift from a sequential approach to one where, in principle, creditors take decisions simultaneously. Consistent with its past role in driving the sovereign debt restructuring process, the official sector should play a leadership role in introducing the necessary changes. It should be noted that such changes would be entirely consistent with the recent evolution of IMF policies, where both in terms of lending into arrears and information sharing, there has been a growing convergence in the way the IMF approaches official and private creditors.

Emerging markets have generally proved relatively resilient to the recent higher interest rates, notwithstanding higher public debts owing to the pandemic. Yet many low-income countries remain in or near debt distress, and, unfortunately, many recent restructuring cases run the risk of laying the foundation for a return to distress when payments balloon after the IMF program ends. Were the global economy to slow sharply—or should rates rise further in advanced economies—conditions could deteriorate for a broader range of countries. We should work hard to ensure that a globally cooperative framework for debt treatments is in place and fit for purpose.

31 Indermit Gill and Lee C. Buchheit, "Targeted Legislative Tweaks Can Help Contain the Harm of Debt Crises," Brookings Institution, June 27, 2022, <https://www.brookings.edu/articles/targeted-legislative-tweaks-can-help-contain-the-harm-of-debt-crises/>.



© 2024 Peterson Institute for International Economics. All rights reserved.

This publication has been subjected to a prepublication peer review intended to ensure analytical quality. The views expressed are those of the authors. This publication is part of the overall program of the Peterson Institute for International Economics, as endorsed by its Board of Directors, but it does not necessarily reflect the views of individual members of the Board or of the Institute's staff or management.

The Peterson Institute for International Economics is a private nonpartisan, nonprofit institution for rigorous, intellectually open, and indepth study and discussion of international economic policy. Its purpose is to identify and analyze important issues to make globalization beneficial and sustainable for the people of the United States and the world, and then to develop and communicate practical new approaches for dealing with them. Its work is funded by a highly diverse group of philanthropic foundations, private corporations, and interested individuals, as well as income on its capital fund. About 12 percent of the Institute's resources in 2023 were provided by contributors from outside the United States.

A list of all financial supporters is posted at
<https://piie.com/sites/default/files/supporters.pdf>.