
# Issues in Domestic Sovereign Debt Restructuring

ESCAP: EXPERT GROUP MEETING ON PUBLIC DEBT AND SUSTAINABLE FINANCING IN ASIA AND THE PACIFIC

NOVEMBER 30, 2022

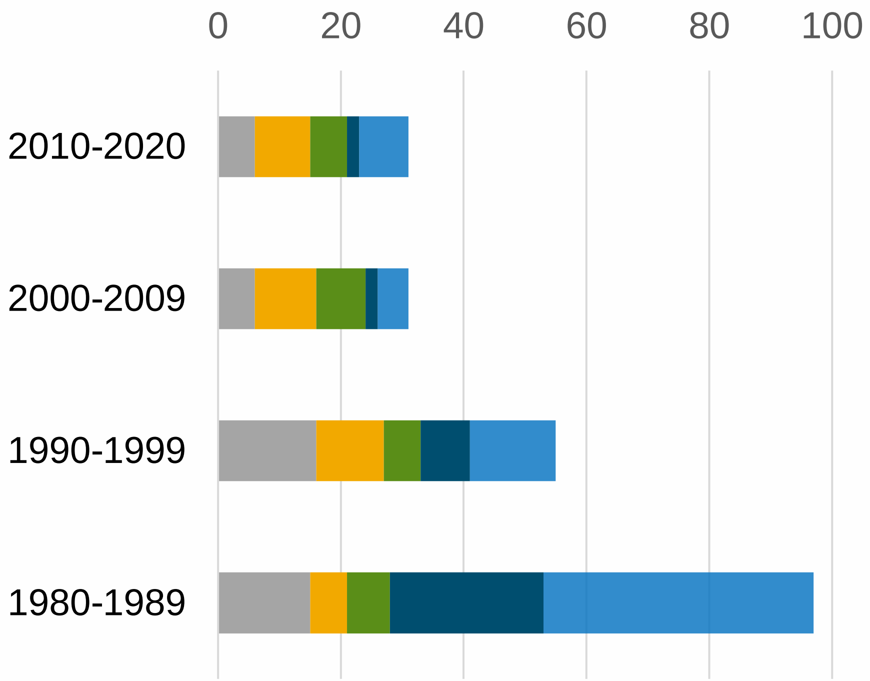
# Outline

- Takeaways from Sovereign Debt Restructuring Experiences during 1980-2020
- Considerations For Restructuring Sovereign Domestic Debt
- Mitigating Spillovers
- Conclusion

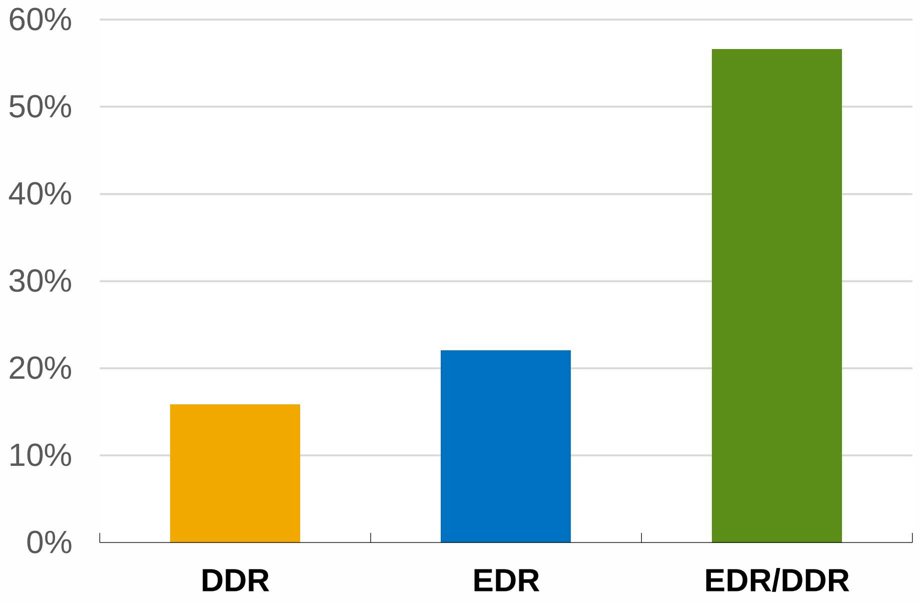
# Domestic Debt Restructuring is More Frequent Now

- ***DDRs** – triggered by external shocks or recessions, but rarely by banking crises*
- ***EDR/DDRs** – often preceded/accompanied by banking crises, more stressed economic conditions*
- *Scale of restructuring and creditor losses tend to be larger in **EDR/DDRs** than in **DDRs***

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




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



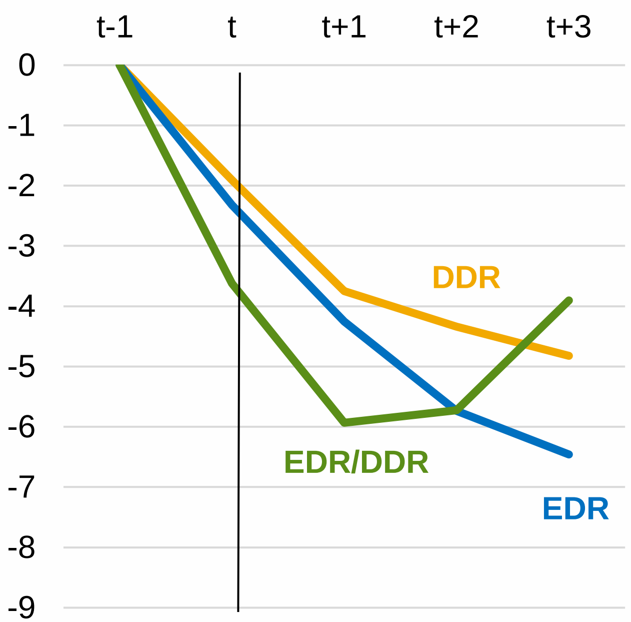

**EDR** = standalone external debt restructuring,
**EDR/IFR** = EDR accompanied by IFR
**EDR/DDR** = EDR accompanied by DDR

**IFR** = high inflation/financial repression
**DDR** = standalone domestic debt restructuring

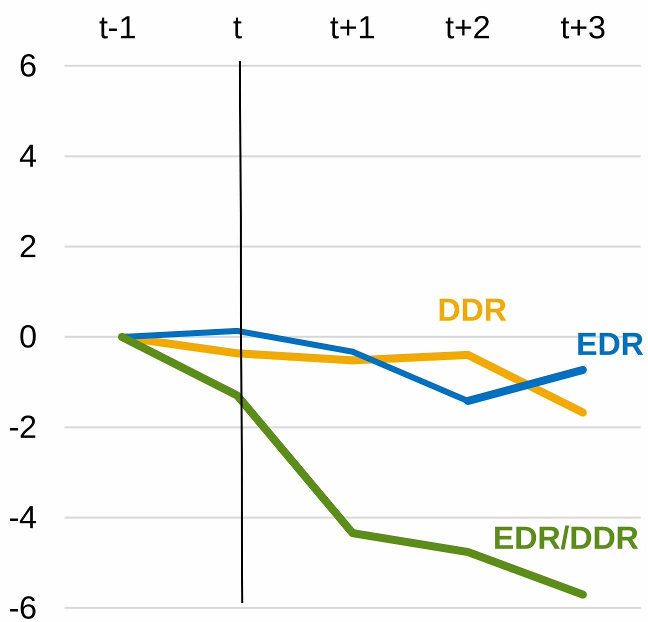
# Post-Restructuring Macro-Financial Patterns

- *Output and credit contractions tend to be sharper after* ***EDR/DDRs*** *than after* ***DDRs***
- *Little evidence that external financing channel is impaired after* ***DDRs***
- *Both domestic and external financing channels are negatively affected after* ***EDR/DDRs***

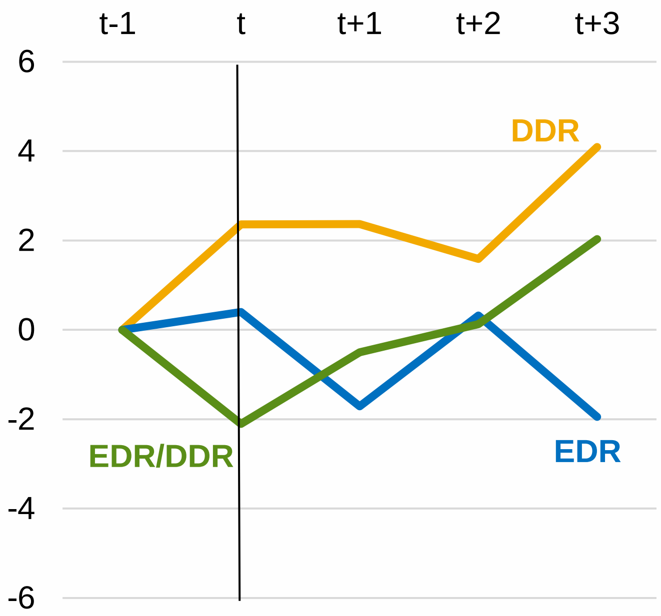
**Real GDP**
*(cumulative change, percent)*




**Domestic Credit/GDP**
*(cumulative change, percentage points)*



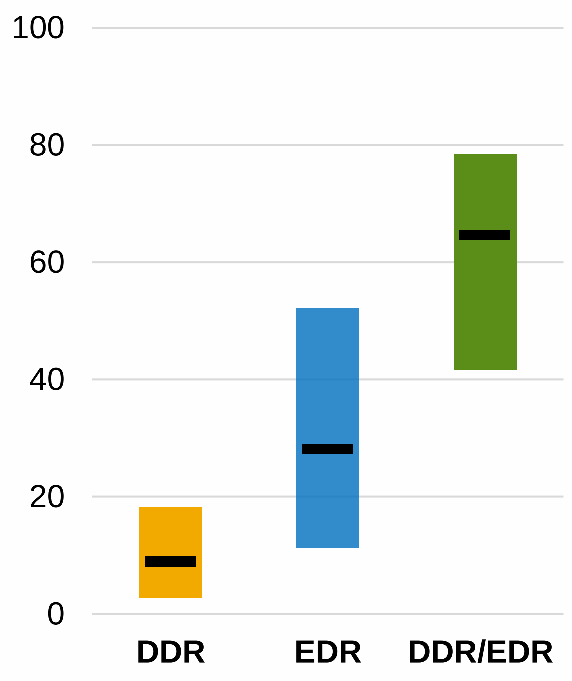

**Gross Capital Inflows/GDP**
*(cumulative change, percentage points)*



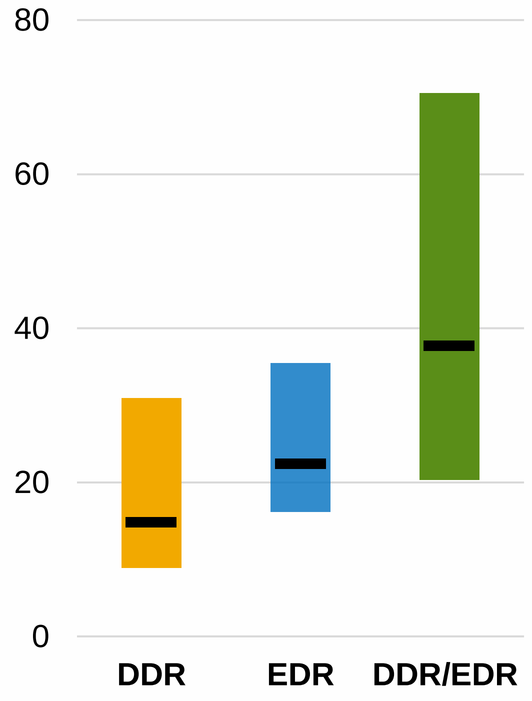
# Considerations For Opting to Restructure Domestic Debt

*Reliance on external private creditors and depth of domestic financial system tend to be much lower in **DDRs** than in **EDR/DDRs***

**External public debt to private creditors**
*(percent of public debt, median & interquartile range)*




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




### *Key Considerations*

- **Severity of shock & distress**
- **Scale of the debt problem**
- **Public 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<br>Domestic NBFIs<br>Public Sector Entities<br>Other Domestic Non-Financial Institutions | *Assess potential costs of mitigating:*<br>*1. macro-financial implications*<br>*2. adverse effects on market access*<br>*3. creditor coordination and holdout risks*<br>*4. political economy considerations* | |
| Foreign private creditors | *Assess potential costs of:*<br>*1. capital outflows, BoP and FX pressures*<br>*2. macro-financial implications*<br>*3. adverse reputational effects on market access*<br>*4. creditor holdouts and collective action issues(/options)*<br>*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

# 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)
  - ***Evaluate potentially adverse consequences of “local law advantage”***

- **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 the event of a DDR as the financial system will already be in a vulnerable condition
- **A DDR will have a direct impact** on the balance sheet and earning potential of financial institutions **leading to capital shortfalls**
  - 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 leading to deposit runs and fire sale of assets
  - Capital flight resulting in 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
  - Establish financial sector stability fund to provide liquidity and capital support
- **Temporary capital flow management** measures may be required to reduce the 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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# Conclusion

- **When**: **net debt relief target** —rather than gross—after fiscal costs
  - Also consider *ex-post* 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 domestic 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