

# THE BRETTON WOODS COMMITTEE

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## Private Sector Engagement and Equitable Burden Sharing: A New Paradigm

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This publication reflects the Bretton Woods Committee Sovereign Debt Working Group's (SDWG's) exploration of how to increase sustainable flows of private capital to, and accommodative debt relief for, emerging and developing economies.

### I. INTRODUCTION: THE CASE FOR URGENT ACTION

The question of how best to encourage and expand the role of the private sector in meeting the financing and debt relief needs of the developing world has been a long-standing challenge. Today, however, finding an answer has become urgent. The Covid-19 pandemic forced most countries—including poor and middle-income countries—to increase public expenditures to meet the ballooning health and welfare needs of their citizenry, while at the same time saddling them with heightened levels of public indebtedness and debt service.

Today's reality has become even more dire. The ongoing war in Ukraine, spiking inflation, rising interest rates, and a strengthening US dollar together have sharply increased the debt burdens of many countries, pushing their refinancing risks toward crisis levels.<sup>1</sup> According to the International Monetary Fund (IMF), nine countries were in debt distress by end-February 2023, and 27 others were at high risk of experiencing debt distress. Several lower-middle-income countries also are similarly afflicted.

At the same time, the flow of private capital to emerging markets has slowed. In fact, net fund flows to emerging markets turned negative last year.<sup>2</sup> Thus, both the scarcity and cost of new funding are compounding the distress facing these fragile economies.<sup>3</sup>

The official sector, led by the Group of Twenty (G20), has acknowledged the precarious position of the poorest countries; initiatives were launched in April and November of 2020—the Debt Service Suspension Initiative (DSSI) and the subsequent Common Framework for Debt Treatments beyond the DSSI (the Common Framework), respectively—intended to ease the near-term debt burden of these countries and to facilitate external debt adjustments.<sup>4</sup> Each of those initiatives contemplated private sector participation as a critical element.

The results thus far have been disappointing. The private sector declined to participate in the DSSI due to concerns over unintended consequences and their own fiduciary duties. And the Common Framework has not led to the resolution of sovereign debt challenges as quickly or as effectively as had been hoped, largely due to the failure of official creditors to agree on a common approach to each restructuring. At the same time, while China’s strategic Belt and Road Initiative previously had been associated with explosive growth in Chinese lending to developing countries, more recently new lending has been cut back sharply.

Most important, despite the two G20 initiatives, the current debt resolution framework, such as it is, is perceived by both practitioners and analysts to be fundamentally inadequate.<sup>5</sup> Given the post-Covid pullback in Chinese lending and the lack of progress between Western advanced economies and China in developing a coordinated approach to sovereign lending and restructuring, the provision of official sector debt relief has faced notable difficulties and delays.

At the same time, efforts to increase private sector lending to poor and middle-income developing countries have been sporadic and ineffective, including broadly supported initiatives such as efforts to increase transparency and to improve the reliability and dissemination of basic economic data. The Chair’s summary of discussions at the June 21–22 Paris Summit states that the participants committed “to mobilize the resources it takes to meet” the current climate, nature and development challenges, “especially on the private sector side.” That said, the Summit focused on setting the agendas for task forces and future studies, rather than on endorsing practical and actionable ideas. This report is intended to help fill this gap.

Public officials typically have argued that the issues of fair burden sharing and the effectiveness of debt restructuring should be resolved primarily by the official sector, with the private sector following its lead, based on the relatively small contribution of the private sector to capital flows to developing economies—compared with official and bilateral lending.

The facts suggest that the reality is more nuanced. For the poorest countries, private creditors accounted for 21 percent of external government and government-guaranteed debt at the end of 2021, bilateral lenders accounted for 32 percent, and multilaterals (which do not restructure their debt) accounted for 47 percent.<sup>6</sup> Lower-middle-income countries had approximately \$3.6 trillion of public and publicly guaranteed external debt outstanding at the end of 2021, of which 61 percent was owed to private creditors.

In this context, two key interrelated challenges will have to be faced: First, an effective and efficient means of restructuring sovereign debt that encompasses both public and private lenders must be developed quickly, lest the expected imminent wave of debt distress cases festers into protracted paralysis. Second, means must be sought that would increase the sustained and sustainable flows of private capital to emerging and developing countries, lest the lack of capital

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inhibit the growth potential of such economies well into the future. The second challenge is the principal focus of this publication, although the interrelation is clear between private capital flows and the existence of a predictable and acceptable framework for dealing with debt distress—that is, one perceived as providing fair burden sharing in such cases—as the latter would increase access to funding in the first place, thus lowering the risk of distress.

## The Challenge of Increasing Private Sector Engagement

Official sector financing was never intended to be the sole source of funding for developing countries: Gaining or regaining market access has been (and remains) a cardinal objective of IMF-supported economic policy programs, as well as sound financial policy for local debt management offices. A significant increase in financing from the private sector is widely considered to be essential to meet the development needs of lower-income countries.<sup>7</sup>

For the intended increase in private sector capital flows to occur, however, the SDWG’s analysis indicates that official sector derisking of private investment will be required in certain circumstances. Moreover, for the design and scale of official sector action to be both appropriate and effective, a clear understanding will be necessary regarding the differing motives and incentives that drive official and bilateral lenders, on the one hand, and that drive private investors, on the other.

For their part, borrowing countries also must be willing and able to accommodate the legitimate concerns of their stakeholders, including lenders’ concerns regarding transparency, good governance, and the prudent expenditure of public funds.

From the perspective of private investors, the two critical considerations in evaluating opportunities to fund the world’s neediest borrowing countries (in addition to the issues of transparency) are (1) whether the opportunity reflects market terms and conditions and presents reasonable risk-adjusted returns and (2) in moments of financial stress—when debt relief may be necessary—whether the restructuring process results in fair burden sharing. This last concern can only be achieved, however, if the restructuring process is viewed as transparent and fair, while investors’ objectives of preserving capital and obtaining reasonable risk-adjusted returns are recognized as legitimate. Of course, the broader goal is to allow these countries to realize their potential for economic growth or, if in distress, to cope effectively with threats both to growth and to financial stability.

Despite the growing number of sovereign borrowers in or at high risk of severe distress, what is lacking at present is consensus among official and private market participants as to their respective roles and responsibilities in maintaining adequate funding to emerging and developing sovereign borrowers.

A good starting point is to reimagine the role and mission of the official sector and to incorporate into that mission the objective of mobilizing private

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capital to fill needs that it cannot satisfy on its own. Leveraging official institutions' balance sheets and their preferred creditor status, while derisking certain types of investment—if carried out sensibly and responsibly—will not only increase capital flows to deserving sovereigns but should facilitate debt relief efforts—when unavoidable—as interests among official and private sector creditors will be better aligned.

In fact, good models exist for public and private sector cooperation that demonstrate the benefits of risk sharing and the catalytic effect it can have on both inflows of private investment and constructive engagement in workout situations. Chief among those is allocation of risk as exemplified by such practices as public-private partnerships, partial guarantees, and A/B cofinancing that extend the protective umbrella of preferred creditor status to private parties investing alongside official ones. Such a structure was a critical element in cementing creditor support for Greece's restructuring of government bonds in 2012.

Expanding on these cooperative efforts could give practical, substantive content to the questions of how the official and private sectors should view their roles and how institutions with very different missions can in practice support each other's objectives. Such a task would require contractual and political creativity and political will, but, if successful, could help achieve the matched goals of increased capital inflows and more effective financial workouts in cases of debt distress.

With regard to burden sharing, the significant gating issue is not the determination of the best mathematical formula with which to measure comparable treatment of creditors in a restructuring. Rather, a more completely and broadly shared view of the roles of the official and private sectors in providing funding—and, when needed, relief—to sovereign debtors is called for. The undercurrent of distrust and suspicion on both sides that prevails today provides ample evidence that there is little consensus on or mutual understanding of the roles and objectives of private and public actors and the constraints affecting each. Without consensus on these basic characteristics, it is futile to think that agreement can be reached on principles of comparable treatment.

One reason for the lack of progress to date in forging a broadly agreed framework on sovereign debt treatment is the inability of the Paris Club lenders and China to reach a shared understanding regarding the treatment of specific lending institutions. However, it does not follow that a consensus on how to manage debt relief and encourage greater private sector participation cannot be forged.

The SDWG's analysis indicates that contractual improvements, market-based initiatives, and, potentially, national legislation also have roles to play in improving the current architecture. In addition, it would be worthwhile to assemble a catalog of good practices—a best-practices menu of options—that reflects agreements struck in actual debt management transactions.

In this regard, it is hoped that the recent formation of the Global Sovereign Debt Roundtable by the IMF, the World Bank, and the Indian G20 Presidency will represent a useful step forward. The Roundtable is a high-level committee comprising both official and private sector representatives that will attempt to bridge existing inconsistencies and forge a consensus regarding the treatment of sovereign debt. Its work is just beginning, however.

This paper is divided into three parts:

- an in-depth examination of the relationship between the official sector and the private sector, and how the roles of the principal stakeholders can best be reimagined so as to increase capital flows in normal times and to secure adequate debt relief when needed;
- a close look at tools that could be used to drive greater private sector participation if the official and private sectors were to better align their interests—including greater use of market-based solutions, as well as contractual and legislative actions designed to derisk investment, expand private sector lending, restore market access, improve debt management processes, and generate adequate debt relief; and
- an analysis of the issues of fair burden sharing and broad and equitable participation in debt relief, which are key focal points of the relationships among official creditors as well as between the official and private sectors.

## II. PRIVATE SECTOR ENGAGEMENT

### A. Rethinking the Relationship between the Official Sector and the Private Sector

The architecture for sovereign finance has been constructed based on a few fundamental principles that have informed its development and operation for decades. Those principles are anchored on a belief (grounded in reality) that the official sector should play a central role in providing funding to developing countries and that international financial institutions including the IMF and the World Bank—together with the regional development banks—are best positioned to meet the urgent development needs of such countries and assist them through periods of financial stress. Those principles remain as true today as they did at the time the aforementioned organizations were created. In today's financial environment, however, the quantum of funding needed to meet the critical health, safety, and development needs of countries in or at risk of distress is overwhelming the ability of the official sector and international financial markets to provide adequate resources through traditional approaches.

Nonetheless, it seems obvious that regardless of whether increased official sector funding materializes, the architecture for sovereign finance needs to be updated so that the private sector can effectively and efficiently contribute more resources to help address these needs. For countries that are prepared to follow

sound policies and live with the implications of participation in international financial markets, access to these markets will allow them to grow and prosper even in today’s challenging market environment. For those countries unwilling or unable to access these markets, the official sector should focus on preparing them for the day when they can or should be accessing international markets.

What is absolutely clear, as the DSSI and the Common Framework have demonstrated, is that unless the official sector fundamentally changes its approach to the critical objective of enhancing voluntary private flows, the private markets—reflecting their own mission and mandate—will not respond with the urgency and scale necessary to alter the current trajectory of events.

In sum, if the official sector were to see the private sector as its ally and partner and its mission were reoriented to prioritize the mobilization of private capital, the official sector’s approach almost certainly would be different than at present. Indeed, some official institutions (such as the International Finance Corporation [IFC] and the Inter-American Development Bank [IADB]) clearly view their mission as including this role when it comes to funding the financing needs of private sector corporate borrowers. Moreover, the approach and products they offer their clients, including A/B loan structures (linked public and private loan arrangements that provide indirect credit support for the private sector) and public sector partial risk insurance, reflect this expanded mission.

The official sector, however, does not generally embrace such an approach when it comes to current sovereign lending practices and certainly not when it comes to sovereign restructuring, where control of the process and priority in treatment vis-à-vis the private sector are the organizing principles.

Faced with a choice between new direct lending and third-party credit support for private lending—where each approach makes equal demands on official sector capital—the official sector inevitably will choose the former. But initiatives such as A/B loans, partial credit support, and, as discussed below, a potential synthetic stabilization fund could catalyze incremental private sector lending that would expand the quantum of resources available while allowing the official sector to devote more of its resources to highly indebted countries that are unlikely to be able to attract private capital on almost any terms.

At the same time, a strengthened sense of partnership between the official and private sectors would reduce the occurrence, severity, and contentiousness of sovereign debt restructurings, advance progress toward common goals—including a return to market access—and, in turn, strengthen critical support behind countries’ efforts to improve governance, informational transparency, and fiscal discipline.

Similarly, both financing and restructuring outcomes would be improved if a new financial architecture provided incentives for private sector participants to temper their preference for treating every sovereign restructuring as if it were sui generis and its reflexive opposition to “top-down” initiatives. Instead, private sector participants could consider whether it was possible to

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agree beforehand on a set of terms and conditions under which they would be prepared to commit to deploy greater capital and approach each restructuring with a view to prioritizing the chances of success, rather than minimizing their share of the burden.

To make progress on these objectives, both the official and private sectors must embrace this opportunity and work together to change not only the discourse but also the goal. If the objective is to increase the flow of funds to sovereign borrowers that have lost or never had access to international financial markets and to reduce the likelihood, shorten the duration, and decrease the cost of sovereign defaults (including the human costs associated with prolonged defaults), then each will need to have a greater appreciation of the constraints under which the other operates. To that end, and before considering some of the specific tools that should be considered in expanding the role of the private sector in these efforts, it is critical to have a common understanding of the roles played by, and the constraints applicable to, the official and private sectors.

#### a. The Official Sector

The official sector can be thought of as including three separate groups of actors—the Bretton Woods Institutions (the IMF and the World Bank); other multilateral financial institutions, especially the regional development banks; and official bilateral lenders—whose objectives and missions overlap in varying degrees.

- The IMF and the World Bank together occupy unique and central positions in the international financial system, playing the leading roles in assisting emerging market sovereigns navigate periods of financial stress and promoting growth and development. Together, they are uniquely able to effect systemic change. Moreover, they have numerous—and in some cases, unique—tools at their disposal. Perhaps because of a concern as to unintended downside consequences, however, they have been reluctant to convert the broad policy preferences that they openly champion—such as better governance, transparency, and greater fiscal accountability—into specific policy requirements backed by direct or indirect enforcement mechanisms (such as withholding aid from non-compliant countries). Further thought as to how best to promote needed change would seem warranted.

Although these organizations have an admirable track record when it comes to responding to the needs of particularly vulnerable members of the developing world in times of crisis, they tend to favor incremental steps rather than fundamental changes in the architecture and rules of the road of sovereign finance. Of course, a change to a more activist stance would require the explicit endorsement of the institutions' member country authorities, acting through their executive directors.

- Apart from the IMF and the World Bank, the bulk of the other international financial institutions (collectively, IFIs) active in the emerging and developing country markets are made up principally of regional multilateral development banks (MDBs). Like the IMF and the World Bank, the MDBs are political institutions, and their lending decisions and activities reflect policy choices of their shareholders. As they rely in part on capital markets for their funding, they—like private sector borrowers—are attentive to their own credit ratings and funding costs. They lend to support policies and projects, and they have partnered with private capital in different lending programs to promote sectoral, industry, or public policy goals, such as ESG (environmental, social, and governance) objectives. Like other official sector lenders, however, MDBs can exhibit a conflicted attitude toward the private sector, embracing its participation in funding capital projects on the front end of the project cycle but tending to stand back when those projects run into stress and financial difficulty.
- The third group often included under the “official sector” rubric consists of bilateral lenders, the largest of which by far in the emerging markets are Chinese lending and development institutions. Bilateral lenders’ public purpose is, as one would expect, closely tied to their country’s own economic and political interests, including promoting exports and securing access to scarce natural resources. Virtually every developed economy has agencies or instrumentalities that serve these ends.<sup>8</sup> Bilateral lenders can provide support to sovereigns through a variety of means, such as direct lending, full or partial guarantees, credit or political risk insurance, and concessionary grants. Not surprisingly, most bilateral lenders have experience in restructuring (in or outside the Paris Club) and, at least in private, may be more understanding of private sector concerns than the IFIs.

Each of the major players in the official sector welcomes private investment, particularly for large capital projects. In fact, they often promote such involvement, as—for example—does the IFC through its A/B loan programs. At the same time, these lenders categorically insist that public monies should not be used to “bail out” private investors in default situations, and that official sector debt should receive preferred treatment over private sector debt in sovereign restructurings (if not carved out of the restructuring altogether).

Moreover, the IMF, the World Bank, and other official lenders claim—and are accorded—what is referred to as “preferred creditor status,” a quasi-senior position that is not embodied in contractual lending arrangements and not precisely defined. Indeed, where circumstances compel it, these institutions may refinance outstanding indebtedness, extend and modify payment terms, and, in the case of the Heavily Indebted Poor Countries (HIPC) Initiative, even accept a reduction in principal.

But without clear rules or definitions, the official sector actors sometimes see their preferred creditor status and public purpose as justifying an elevated role



in any restructuring process and in setting parameters as to what the outcomes may be. They can be less sensitive to private sector concerns and how the private sector sees its role than they perhaps should be. They also believe that whenever they are called on to provide debt relief, the private sector should be willing to do the same, whether or not issues of importance to the private sector—such as transparency, governance, and fiscal discipline—have been addressed adequately.

## b. The Private Sector

Like official sector participants, private sector financial institutions invest in sovereign debt for a variety of reasons and bring different approaches and perspectives to the task. Although all of them share a desire to earn a return on their investment, their investment horizons, return expectations, risk tolerance, and ability to endure (or take advantage of) shocks and turmoil differ substantially.

- Those with the largest footprint, at least from an assets-at-risk perspective, are the large “real money” asset managers, such as Blackrock and Fidelity, that acquire securities primarily in the new issue market for sovereign debt. For such investors, emerging market sovereign debt is a separate asset class that can help diversify their clients’ portfolios and, at times, generate attractive risk-adjusted returns. These investors have choices over where to invest, and during “risk-off” times or when risk-adjusted returns are more attractive elsewhere, they can and do withdraw money from the sovereign markets and invest it in alternative formats, such as corporate debt.

Because such institutions may manage trillions of dollars at any given time, they tend to rely heavily on rating agencies and research coverage from financial intermediaries before making an investment decision, and they prefer that their investments are structured and documented in a manner that is well known to financial market participants, shying away from novel or unusual lending arrangements and complexity. Above all else, they require a liquid market for their investments (typically unsecured bonds), which they mark to market on a regular basis.

When it comes to restructurings, these investors are generally not the first to commence litigation, although they may be the first to exit their investments in the case of payment default or a distressed exchange offer.<sup>9</sup> On the other hand, in recent restructurings—such as those in Argentina and Ecuador—some of these investors have played a critical role in providing debt relief to distressed sovereign borrowers, showing a willingness to accept a reduction of their debt (on both a nominal and net present value basis) and to provide distressed sovereign borrowers a respite intended to permit the debtor to carry out needed economic adjustment.

- The group of private investors that receives the most press coverage, and whose behavior attracts the disproportionate attention of many sovereign

commentators, are those financial institutions (so-called vulture funds) that purchase their investments in the secondary market at a substantial discount, with a view to seeking an outsized recovery through aggressive tactics such as litigation or sitting out a restructuring and seeking a par recovery in the aftermath. These are not buy-and-hold investors. On the friendlier end of the spectrum—when a quick profit may seem a more distant prospect—some of these same investors also have shown their ability to provide debt relief to distressed sovereigns and, in the case of Barbados and Belize, to participate in innovative solutions, such as debt-for-nature swaps. One shouldn't forget that by acquiring securities at a substantial discount to the original face amount, they (and the investors who sell at these low prices) allow distressed sovereigns to reduce their debt in ways that would be far more difficult to achieve if the universe of creditors consisted solely of original holders that invested at par.

- Finally, leaving aside local institutional and retail investors who may hold securities or loans placed in the host countries' domestic markets, the other major private sector investors in emerging markets are international banks and commercial enterprises (Glencore, for example). The former provide significant finance to support the activities of emerging market sovereigns through trade and project finance, syndicated loans, repos, or other extensions of credit; the latter provide finance primarily to produce the natural resources or other commodities they wish to purchase, often effectively secured by those same commodities.

Although syndicated commercial bank lending no longer is a major source of funding for sovereigns themselves, it persists in scale at the subsovereign level, particularly in the case of revenue-generating state corporations (such as state-owned oil and gas companies), and in trade finance. Commercial banks also provide support to central banks and local development banks through repos, derivative contracts, and other financial products that provide critical liquidity and risk protection to these countries.

Thus, both of these actors merit attention, as the accumulation of significant liabilities or a default under these arrangements can have a material and cascading adverse effect on sovereign borrowers. And in the case of several sovereign restructurings, most notably in the recent case of Chad, these private investors and/or banks can exert enormous influence on the process. Finally, these same commercial banks and large global financial institutions play additional important roles in the financial ecosystem ranging from providing research to intermediating markets to establishing trading indexes, and their internal rules and procedures, and their capital and other regulatory requirements, can have a significant impact on the ability of stressed sovereigns to access funding when they most need it.<sup>10</sup>

Although the various private investors are characterized by differences in their approach, attitude, and goals, they have much in common when it comes to making investment decisions. Moreover, they have developed over the last 40-plus years a creditor committee structure (much as is the case in nonsovereign restructurings) that in many instances facilitates the resolution of intercreditor differences.<sup>11</sup>

In the case of debt restructuring, most private investors strongly believe that such exercises are suitable for case-by-case treatment only, and they do not lend themselves to prescriptive solutions, particularly in an environment where they don't have a seat at the table—when fundamental decisions regarding the scope and terms of a restructuring are being made. If such determinations were not made exclusively by the official sector then perhaps the private sector's skepticism over the process would be reduced and the prospects of reaching debt resolution outcomes satisfactory to all would increase. The recently constituted Global Sovereign Debt Roundtable set up to discuss debt restructuring challenges is a good example of a step in the right direction—it includes the entire breadth of stakeholders, i.e., Paris Club and non-Paris Club creditors, debtor countries, and representatives of the private sector.<sup>12</sup> It is a format that could perhaps be extended to other platforms and processes intended to address sovereign debt policy and specific restructuring situations.

### c. The Choice: Go Big or Go Small (or Do Both)

There is broad agreement that the current international framework for sovereign finance and debt management needs serious reimagination and reform. Indeed, in the aftermath of the pandemic, the official sector itself acknowledged the shortcomings of the current architecture, and responded with the DSSI and the Common Framework. The Institute of International Finance (IIF) similarly has acknowledged the need for reform and has warned of a looming debt crisis in poor and middle-income countries. When it updated its *Principles for Stable Capital Flows and Fair Debt Restructurings* (known as “the Principles”), the IIF also pointed out the shortcomings of the current architecture.<sup>13</sup> A Group of Thirty working group on sovereign debt, as well as many other organizations and commentators, has issued similar warnings.<sup>14</sup>

Although there is agreement on the need for reform, not surprisingly there is disagreement as to specific solutions. At present, the road to reform appears to consist of two alternative paths: one emphasizing incremental changes, and another encompassing bolder, more far-reaching changes. In the view of the SDWG, it is the latter path that holds the most promise of achieving meaningful progress. Even under favorable conditions, however, this will not happen overnight—it requires the reassessment by both the official and private sectors of some of their core beliefs.

The official sector, for example, must decide whether (and to what extent) the potential benefits that would accrue to poor and middle-income countries from

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being able to mobilize increased amounts of private capital and to leverage its own resources justify taking incremental credit risk. The private sector must be willing to participate in a system where diverse creditor interests are more aligned, accepting that it will function better than at present.

In short, there needs to be a fundamental change in the nature of the relationship between the official sector and the private sector—one where they see themselves as partners in a broader effort to mobilize public and private capital and create conditions in debtor countries and the international capital markets that will result in broader access to international markets and more resources flowing to the developing world.

## **B. Greater Private Sector Engagement: The Toolbox**

A bolder reform could encompass a range of specific mechanisms, many of which could be incorporated incrementally into the existing framework and used to increase private sector capital flows in emerging and developing countries. The key point we emphasize is that a wide variety of techniques—a menu of options—that could be used to enhance private sector engagement already exists. We list those options here descriptively rather than prescriptively as their relative advisability will depend on specific circumstances.

The explanation as to why the private sector at present is reluctant to play a more active role in sovereign lending and debt relief is not mysterious.<sup>15</sup> There are, of course, threshold issues—such as the need for more and better information and data, greater procedural fairness, and engagement when it comes to sovereign restructurings. The latter encompasses the inclusion of the private sector earlier in the negotiation process.<sup>16</sup>

Of particular importance in this regard would be the ability of private sector participants—perhaps operating through a creditor committee—to comment on the inputs to the IMF/World Bank’s debt sustainability analysis (DSA) that currently underpins the design of a debtor country’s economic adjustment program and on the specific terms of a country’s debt restructuring under the Common Framework approach, as well as on the choice of measures intended to improve policy implementation.<sup>17</sup>

There is a general view in the private sector, not completely unfounded, that the official sector could do more to leverage its position and link the provision of new funding and debt relief to better policy performance by sovereign debtors. Few would argue with the proposition that progress on these issues would not only increase private sector participation but also benefit all stakeholders and—over time—likely result in more sustainable and resilient sovereign debt burdens.

But beyond these gating items, a series of tools exists that should be considered to expand the participation of the private sector in new money lending and sovereign debt management. Some of the tools are widely deployed already

to attract private capital to corporate borrowers in the emerging markets, and the use of others is on the rise, suggesting that opportunities exist to increase private sector participation within the confines of techniques known to the current financial system. Of course, it also is possible that bolder changes could reap more substantial rewards.

Against this backdrop, three parallel sets of potential actions could be considered:

- First, there are **market-based solutions**, including
  - the recent dramatic increase in so-called impact investing in private markets (including ESG bonds and related instruments)—the challenge is to determine whether the forces that have led to this new asset class could be exploited to accelerate and expand private participation in capital raising and debt relief for poor and middle-income countries;
  - blended capital solutions, combining both official and private finance, notably A/B loans and synthetic stabilization funds; and
  - existing credit enhancement and risk mitigation tools that the official sector now uses largely to support corporate lending—the objective in this case is to explore how these tools can be better utilized to attract and expand new money lending and debt relief to sovereigns.
- Second, **contractual mechanisms** could be used to encourage greater participation in debt restructurings, facilitate reaching and implementing agreements, and mitigate the inevitable uncertainty as to whether an agreed restructuring plan will prove adequate.
- Lastly, **legislative initiatives**, both current and potential, could be considered.

## a. Market-Based Solutions

### i. *ESG Investing: A Model and a Potential Opportunity*

Over the last six years, according to some reports the private sector has dedicated more than \$15 trillion of investment to impact investing, with a focus on addressing issues relating to environmental, social, and governance concerns.<sup>18</sup> Financial products such as green and blue bonds (the latter focused on marine ecosystems) are now a staple of the investment world as investors look for opportunities to use their savings at least in part to advance or optimize outcomes that fall within the category of “socially responsible” investing. Unfortunately, much of that funding has gone to companies and projects in advanced economies, even though the effects of climate change have had a disproportionate impact on the developing world.<sup>19</sup> Many emerging market countries particularly are vulnerable to hazardous weather events, other fallout from global warming, and rising levels of greenhouse gas emissions.

The capital markets have welcomed several instruments designed to accommodate these investment choices, and emerging market sovereigns have begun to tap their potential (see Box 1).

### **Box 1. ESG Investing: The Potential of Next-Generation KPI Instruments**

GSS bonds are bonds issued with the stipulation that proceeds will be used to fund green, social, and sustainable, or GSS, projects. GSS bonds were initially issued only by private sector firms, with Poland being the first sovereign to issue a GSS bond in 2016. Currently, GSS bond issuances by sovereigns constitute between 10 and 15 percent of the GSS bond market.<sup>20,21</sup>

More recently, market participants have developed so-called sustainability-linked bonds (SLBs) or key performance indicator (KPI) bonds, where the interest rate on the bond is tied to the issuer's fulfillment of predefined sustainability (including fiscal sustainability) targets within an agreed time frame.<sup>22</sup> These instruments are relatively new, with the first SLB/KPI bonds issued in 2019. To date, the only sovereigns to issue SLB/KPI bonds have been Chile and Uruguay, both of which issued SLB/KPI bonds in 2022.

SLB/KPI bonds could prove to be a potentially attractive tool when it comes to increasing the flow of funds to poor and middle-income countries and improving sovereign restructuring outcomes if three hurdles are addressed. The first is generating greater awareness in the impact-investing community of the needs and benefits of addressing the health and welfare needs of these countries and why those objectives fit squarely within the ESG agenda. The second is developing a set of specific KPIs that will link the investment dollars raised to the advancement of these goals. And third, is finding a way to price these instruments in a manner the market will embrace.

Whereas the new financial instruments are a welcome addition to the potential capital-raising tool kit of any emerging market sovereign, stressed or otherwise, when it comes to the developing world, the ESG agenda as a whole has been limited largely to climate and sustainability issues, and has only just begun to stretch to cover broader social issues. It has not, for example, included many of the broader challenges that many poor and middle-income developing countries face, including income inequality, historic underinvestment in critical infrastructure, food insecurity, and dire health and welfare issues triggered by poverty and climate change—conditions that are often compounded by such countries' inability to access lower-cost funding.

Given the large and growing pools of capital available today for impact investing and the potential this capital offers for providing much-needed relief to struggling countries, it would seem that the ESG agenda could naturally be expanded to include and focus on these challenges in a more robust way? This pool of private capital, and the lower cost of capital it potentially offers emerging market countries in or facing distress, is a resource that likely could be exploited further.

There likely are multiple explanations as to why this has not happened. The mission of aiding poor and middle-income countries historically has been left to and led by the official sector. To unlock this resource, the official sector will need to take a leadership role in making the case to the ESG community as to why this funding is necessary and how it could make a material difference and in providing credit enhancement in one form or another where credit quality is a consideration.

Although there will be definitional issues to address and overcome, it shouldn't require much of an intellectual leap to develop a specific set of KPIs focused on advancing these important goals. KPIs centered on issues—such as improving governance and transparency, reducing income equality, capacity and institution building, food security, and prudent fiscal management—that are tailored specifically to vulnerable countries that lack the institutional capacity to access markets and attract traditional funding from the private sector could offer a path to countries willing to embrace reform in exchange for lower funding costs and expanded access to capital. No doubt, any proposed KPIs would need to give developing countries time for these reforms and changes to occur, but if and when they were successful they could provide important benefits to their populations while strengthening their financial resiliency.

This next generation of KPI bonds does not need to be limited to new money financings. KPIs could be developed and introduced into sovereign restructurings with the goal of either attracting impact investors to help refinance existing debt in or near default or expanding the pool of capital that participates in distressed exchanges. The specific road map for how to advance these efforts is beyond the scope of this paper, but this is an area that should receive more attention and become part of the agenda of the sovereign finance and impact-investing communities.

## *ii. The Blended Capital Model*

Recognizing the reluctance of private investors to lend to higher-risk countries, a report from the Group of Seven (G7)–backed Impact Taskforce has recommended greater cooperation between the public and private sectors and the expanded use of blended capital or public-private partnerships.<sup>23</sup> These arrangements allocate risk between the private and public sectors, and if done correctly, provide market-friendly structures and incentives to greater investment by the private sector in higher-risk regions.

Two blended capital schemes of particular interest are A/B loans and synthetic stabilization funds. A/B loans seek to extend the umbrella of an official sector's preferred creditor status to private investors and have been widely used by both the IADB and the IFC (part of the World Bank Group), among others, to support financings for private borrowers (see Box 2).

### Box 2. A/B Loans

The most common way of leveraging the official sector's preferred creditor status is through cofinancings, typically in the form of an A/B loan structure. In an A/B structure, an official lender—traditionally a multilateral development bank or the World Bank's International Finance Corporation—offers to provide the first tranche of the loan, the A loan, and then enlists other lenders to provide the second tranche of the loan, the B loan.<sup>24</sup> The official lender organizing the loan is the lead lender and the administrative agent.<sup>25</sup> If the official lender is the lender of record and the B lenders (which include private sector participants) are providing funds to it and not directly to the borrower, this framework reduces the B lenders' credit risk because they are covered by the A lender's preferred creditor status and can also benefit from its immunity from local taxation in certain cases.<sup>26</sup> Alternatively, an A/B loan structure could implement a cofinancing agreement wherein both A and B lenders lend directly to the borrower, but payments on both loans are made to a common paying agent and allocated pro rata as between the A and B loans. Under such an arrangement, the debtor could not avoid paying private creditors without at the same time defaulting on the official sector.<sup>27</sup>

The G7's recommendation of greater use of blended finance is echoed by others in the international financial community, particularly when it comes to assisting with the financing of projects related to combatting global warming, as climate finance faces several particular challenges when it comes to attracting private capital.<sup>28</sup> The message is clear: the needs of the developing world to manage and protect itself against climate risks are substantial and can only be met by the joint efforts of both the official and private sectors.

Consistent with the G7 recommendation, the official sector should be assuming a larger role in mobilizing private capital and offering a greater array of blended capital solutions than has been the case to date. To mobilize the necessary level of private funding, IFIs will have to consider programs that include special-purpose lending arrangements—such as public-private partnerships—where a portion of the risk is assumed by the official sector, as well as arrangements that provide official sector support to private investors through first-loss mechanisms, partial risk guarantees, insurance, or other measures that can make these investments more attractive to the private sector. This approach, rather than efforts to compete with the private sector, could expand materially the financial resources available to at risk sovereigns. Of course, assurances as to good governance and strict accountability over expenditures and performance will be necessary to avoid the moral hazard associated with providing public support to private capital—in order to avoid the risk that losses become socialized while gains are privatized.

The inclusion of officially supported GSS (green, social, and sustainable) or KPI bonds in sovereign debt restructurings also can encourage private sector participation in these liability management exercises. In the recent Belize restructuring, both the US International Development Finance Corporation



and the not-for-profit Nature Conservancy provided financial assistance in the form of political risk insurance and new funding, respectively, to help Belize capture a steeper discount and greater participation from its existing sovereign bondholders.<sup>29</sup> Belize agreed to use part of the savings from the bond restructuring to implement tangible marine and conservation measures designed to further biodiversity objectives.

Though debt-for-nature swaps are not new (they have been used in more than 30 countries),<sup>30</sup> their use could be expanded. One key upside to these projects is that “savings” from the projects (in the form of reduced debt service requirements) can be redeployed to the development of projects that can provide immediate benefits. Additionally, they often can generate other returns on investment aside from the specific ESG goals in the form of avoided cost (e.g., expenditure on stormwater or flood protection), incremental revenues (e.g., tourism), and overall growth (through the creation of local businesses to service these projects).

The Belize example notwithstanding, the official sector has yet to fully embrace the potential benefits of this approach. In addition to what appears to be a lack of concentrated focus on the promise of these sorts of initiatives and the practical obstacles that need to be overcome to roll them out, the official sector often falls back on the familiar refrain that public resources should not be used to benefit private capital. This fundamental disconnect will have to be overcome if material and lasting progress is to be made in this area.

### *iii. Synthetic Stabilization Fund*

Resource-rich countries such as Norway, Chile, and Kuwait have established stabilization funds with “excess” (or above “normal” or “benchmark”) revenues derived from the exploitation of oil—and in the case of Chile, copper. The funds are then available to be drawn on by the government to smooth out revenues in periods of downturn. Countries without the wealth required to establish such a fund might nonetheless be able to share many of the benefits of this type of scheme through the use of a synthetic stabilization fund whose resources would be provided by a mixture of public and private funds.

For countries with heightened risk of default and vulnerability to exogenous shocks, having ready access to funds in times of dire need could make the difference between a messy default and a relatively smooth process.

Thus, one proposal worthy of consideration is the creation of a synthetic stabilization fund that could mobilize significant private capital and provide rapid relief to sovereigns that are unable to access financial markets due to exogenous shocks (see Box 3).<sup>31</sup> Such a vehicle likely would be welcomed by sovereign borrowers and, if structured appropriately, would attract the interest of many large asset managers and private financial institutions that are active in emerging markets lending. The attraction is that such a fund would add to the resiliency, and improve the creditworthiness, of many sovereign borrowers.

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**The official sector should be assuming a larger role in mobilizing private capital and offering a greater array of blended capital solutions than has been the case to date.**

The synthetic stabilization fund could avoid or mitigate the need for the official sector to come to the rescue of sovereigns that in normal circumstances are able to tap international capital markets or their own financial buffers, thus saving valuable public resources. Such a fund also would be available to provide interim relief to a debtor country pending satisfaction of the IMF's requirement that before committing its own resources it receive adequate assurances that a restructuring consistent with an IMF-approved economic program is achievable—a requirement that has caused significant delay in current Common Framework restructurings due to official creditors' failure to agree on their contribution.

### **Box 3. Synthetic Stabilization Fund**

A synthetic stabilization fund could be formed as a stand-alone vehicle that would raise funding from the international capital markets (with credit support or junior funding from donor countries or the official sector) at rates that reflect an investment-grade rating. Such a fund would then be able to lend its actual and committed cash resources to eligible sovereign borrowers at a small premium. The loans to the sovereign would secure the underlying debt obligations and instruments issued by the fund. The synthetic stabilization fund could raise different tranches of debt and the official sector would either provide partial guarantees or first-loss protection with respect to the securities issued by the fund so the cost of raising private capital could be minimized and the benefit of low borrowing costs passed on to eligible sovereign borrowers.<sup>32</sup> Many of the blended capital tools and public-private credit enhancement techniques described in this paper could be used to keep such a fund's borrowing costs low, thus representing a saving that could be passed on to the sovereign borrower, while still keeping the risk-adjusted return to private investors sufficient to attract substantial private capital.

Alternatively, one could contemplate using special drawing rights (SDRs) of various advanced economies (Group of Seven countries) to collateralize the debt issued by the synthetic stabilization fund, although such use would have to meet the limitations of use that apply to this reserve asset.<sup>33</sup> This proposed stabilization fund likely would attract the same type of resistance that is raised commonly to most proposed credit enhancement techniques, as outlined previously. Notwithstanding those concerns, a compelling case can be made for such a fund, particularly if access to the fund is limited to sovereign borrowers that historically have had access to international capital markets but have temporarily lost it due to conditions outside their control.

For the synthetic stabilization fund to be effective and available rapidly, sovereigns able to borrow from the fund would have to meet pre-agreed eligibility criteria established at inception. If the proceeds of the fund were used exclusively in circumstances brought on by exogenous events, then there would be less need to tie disbursements from or repayments to the fund to structural adjustments of the sovereign borrower's fiscal policies. If loans by the fund are available to sovereigns in cases where an IMF adjustment program is necessary, then the link between the disbursement and repayment of the fund lending and progress on a specific adjustment program is likely to be explicit and determinative.

In those cases, it might be interesting to consider tools commonly used in the corporate restructuring world, where existing creditors of the distressed sovereign are given the opportunity and incentives—perhaps through a different tranche of securities of the synthetic stabilization fund—to exchange existing debt of the sovereign with debt of the synthetic stabilization fund, perhaps even allowing them to “roll up” a portion of their existing debt as an adjunct to any new money commitments they provide to the fund (which would ultimately be part of the lending to the sovereign).<sup>34</sup>

#### *iv. Credit Enhancements: Guarantees, Insurance, and Other Techniques*

Direct credit enhancement to loans and other investments of private capital can be deployed in several ways to leverage official capital and increase the amount of resources available to countries in or threatened by distress. In general, these techniques have been used previously in many different circumstances.

Credit enhancements most often are provided in the form of a guarantee, insurance, first-loss facility, or other similar assumption of risk by the official sector. Credit enhancements may be tailored to mitigate a set of identifiable risks that can be broadly or narrowly defined to provide financial assurances or guarantees for all or a portion of the investment. In all cases, the objective is to improve the overall creditworthiness and credit rating of the investment in question. The examples of credit enhancement techniques set forth in Box 4 therefore can be viewed as a set of alternatives, with specific choices tailored to specific circumstances.

### **Box 4. Forms of Credit Enhancement**

**Political risk guarantees.** Political risk guarantees cover a variety of so-called political risks (excluding the creditworthiness of the obligor) that might interrupt performance by the obligor, including war, armed violence, expropriation, change of law, currency inconvertibility, regulatory risks, frustration of arbitration, and other force majeure-related events.<sup>35</sup>

**Partial credit guarantees.** Partial credit guarantors absorb part of a debt service default risk, irrespective of the cause of default. Generally, partial credit guarantees have been used to enhance commercial debt instruments held by private lenders.<sup>36</sup> Such guarantees serve as an irrevocable promise to pay the principal and/or interest of a debt up to a predetermined amount.

**Partial risk guarantees.** Partial risk guarantees seek to provide limited protection to the extent necessary to attract the private sector to invest in worthwhile projects in developing countries.<sup>37</sup> Only some of the project risks are covered. For guarantees that cover specific contractual obligations, typically 100 percent of the principal of and interest on the covered debt is guaranteed against the risks that are specifically covered, but default caused by other

risks is borne by the private sector. For guarantees that cover a portion of debt service, typically only the later-year maturities of the underlying debt are covered as a key objective in this case is to help governments borrow with longer maturities from private lenders.<sup>38</sup>

**Project-based guarantees.** Project-based guarantees can take the form of either loan or payment guarantees. Loan guarantees either cover defaults of debt service payments—typically by public sector borrowers and regardless of the cause of the default—or protect commercial lenders financing a private sector project from debt service defaults caused by government action or inaction. Payment guarantees cover defaults of non-loan-related government payment obligations to a private public entity (such as payment for goods or services) where such obligations require credit enhancement.<sup>39</sup> These guarantees may overlap the coverage of political risk guarantees.

**Policy-based guarantees.** Policy-based guarantees protect against the failure of a borrowing government to meet specific fiscal objectives and mitigate the risk of a default in debt service payments owing to commercial lenders.<sup>40</sup>

Nonguarantee credit enhancement mechanisms, such as the following, also represent an available option.

**First-loss provisions.** First-loss provisions provide that initial losses up to a specified amount are absorbed by someone other than the lender or investor.<sup>41</sup>

**Contingent loans.** Contingent loans are a source of emergency finance to debtors to ensure that they can meet their payment obligations in the face of a liquidity issue or an unforeseen external event that threatens their ability to perform. This tool provides comfort to private sector investors contributing to government projects with higher levels of volatility.<sup>42</sup>

**Viability gap funding.** Viability gap funding can be used to cover heavy up-front funding needs. Viability gap funding occurs through a process that finds weak areas in projects that would prevent large-scale funding from being obtained. Once those areas are identified, a funding scheme is implemented through capital grants, subordinated loans, or interest subsidies that are specifically designed to target the identified weak areas, thus opening up the possibility of broader funding for the project.<sup>43</sup>

Credit enhancement mechanisms can be used in tandem to increase private sector participation. For example, in a Chilean project involving the construction of toll roads, the IADB provided both financial guarantees and A/B financing, which extended its preferred creditor status to the private monoline insurers, thereby allowing them to enter the market and participate in the transaction.<sup>44</sup> And in a pipeline project in West Africa, the World Bank offered a partial risk guarantee and the Multilateral Investment Guarantee Agency, an arm of the World Bank Group, offered political risk insurance that would cover payments owed by the government.<sup>45</sup>

Although the official sector has a long history of providing these sorts of credit enhancements to help mobilize funding to private sector borrowers in the emerging markets, it has been much less willing to use such mechanisms

to support regular-way borrowings by sovereigns that are not tied to specific projects and even less willing to use them to facilitate greater private sector participation in sovereign debt restructurings.<sup>46</sup>

Such reluctance most likely stems from several deeply held views many in the official sector share: those include a belief that these sorts of mechanisms are not needed by sovereign borrowers except in the case of those borrowers—mostly very low income—with no access to international financial markets (in such cases, it is easier for the official sector to lend directly on concessional terms); a concern that credit enhancement mechanisms inevitably socialize investment losses and privatize investment gains; the challenges associated with establishing eligibility and implementation criteria for these sorts of credit enhancements that can be applied fairly and universally across different countries; and the risk that if the official sector were to significantly expand its use of these techniques, its own credit ratings and access to low-cost funding would be compromised.

Although the concerns of the official sector are by no means frivolous, the official sector in practice routinely uses such tools to finance projects for emerging market corporate borrowers. This suggests that in the right circumstances, the official sector in fact is willing to “derisk” private sector investment. As the resources of the official sector themselves are limited, leveraging such resources to attract significantly increased private capital appears to represent a priority avenue to explore.

Increased public sector risk, moral hazard, and accounting rules relating to charges against capital are all concerns that can be addressed with ingenuity, an open mind, and a willingness to search for the most symbiotic combination of official and private resources. Despite deeply embedded doubts in the official sector regarding the desirability, feasibility, and prudence of using public resources to enhance private credit, their appropriate use almost certainly could attract additional flows to low- and middle-income countries in need.

## b. Contractual Mechanisms to Encourage Private Sector Participation in Sovereign Debt Restructurings

In addition to market-based tools, a great deal of thought has been given to how to promote greater private sector engagement in lending and debt management through the introduction of contractual arrangements designed for this purpose. Some of these techniques already have been used widely. However, some possible refinements, as well as some new ideas, could be introduced to expand private sector participation in debt restructurings.

### i. *Collective Action Clauses*

***Collective action clauses in bonds.*** A collective action clause, or CAC, is a contractual provision that permits a majority or supermajority of creditors to modify the terms of a debt instrument, including fundamental payment terms

(e.g., maturity, principal amount, or interest rate), in a manner that is binding on all holders.<sup>47</sup> CACs deprive holdout creditors of the ability to block proposed restructuring terms as long as the requisite majority consents to those terms. CACs thus give a sovereign issuer the ability to “cram down” the debt held by nonparticipating or dissenting minority creditors, akin to similar creditor cram-down features available in statutory insolvency regimes applicable to corporate debtors such as US Chapter 11 proceedings and English schemes of arrangement.

CACs are not new contractual innovations and have been commonplace in English law–governed bonds for over a century. However, it is only since 2003 when Mexico first included CACs in its New York bonds, and the official sector abandoned its ill-fated efforts to launch an international bankruptcy regime for sovereigns (the Sovereign Debt Restructuring Mechanism, discussed below), that their use in New York law sovereign bonds became widespread. In the years since, their acceptance by private sector creditors has become commonplace, the terms of market standard CACs have evolved, and their use has become a standard (if not always uncontroversial) feature of recent sovereign debt restructurings. As of end-March 2020, it was estimated that only 4 percent of foreign law–governed sovereign bonds did not contain some variety of a CAC.<sup>48</sup>

Much has been written about CACs, and the details of their operation will not be repeated here.<sup>49</sup> Variants today allow the modification of more than one series of bonds with voting across different series, as well as on a series-by-series basis. The Argentine and Ecuadorean restructurings in 2020 illustrated both the effectiveness of CACs as well as unintended flaws in their design. Clearly work remains to be done to fine-tune the operation of CACs so that they can be even more useful tools to facilitate restructurings.

Prior to the Argentine and Ecuadorean restructurings, it is fair to say that CACs were viewed as a mechanism to ensure that all bondholders would be subject to the same restructuring terms if the requisite majority voted in their favor. In those two recent restructurings, however, a new paradigm was introduced whereby if proposed modifications were approved by the requisite majority, all bonds would be replaced by new bonds, but the new bonds issued to bondholders who failed to vote in favor of the proposed modifications would have terms substantially less favorable to them than the bonds issued to holders who voted in favor. This result is at odds with how statutory insolvency regimes work, but it demonstrates the challenges associated with effecting a restructuring in the absence of such a regime.<sup>50</sup>

The final terms of the Argentine and Ecuadorean restructurings reflected a first attempt to fix the most egregious (and seemingly unintended) issues created by what was then considered standard CAC language that surfaced in the restructuring negotiations and that are referred to above and in endnote 50. Not everyone agrees that the resolutions reached in these two cases are ideal and should be the new standard.

Another, equally important issue with the so-called standard model that was not addressed by Argentina or Ecuador is the procedure provided for modifying multiple series of bonds on the basis of a single cross-series vote, with no series-by-series vote of bondholders. In this case, the standard and current version of CACs today allows for modification of bond terms on the basis of a single cross-series vote only if all affected bondholders receive the identical instrument in the restructuring—that is, if all bondholders receive a new bond with the same interest rate, amortization, and maturity.

This result could significantly lengthen the duration of original bonds with shorter maturities and reduce the duration of later-maturing original bonds. Similarly, some bondholders might benefit from an increase in interest rate as a result of the restructuring while others might actually see a decrease. Although such a result is consistent with treatment in a US Chapter 11 proceeding, it is inconsistent with official sector practice, which determines equivalent treatment on the basis of net present value, as well as with current practice in sovereign restructurings generally.

It would not be surprising if improved model CAC documentation were developed and accepted by the market. Additionally, there remains a large outstanding stock of international sovereign bonds without the latest iteration of CACs. It is hoped that over time as enhanced CACs become more and more normalized in the sovereign bond market and older bonds with standard CACs mature and are replaced with new bonds, the sovereign bond market will become homogenized, at least as regards CACs. This undoubtedly will increase their use and effectiveness in future sovereign debt restructurings.

## *ii. Majority Voting Provisions in Syndicated Bank Loans*

The Bank of England recently offered several recommendations regarding ways to expand and make more effective private sector engagement in sovereign debt management in the case of syndicated bank loan agreements as opposed to bond documentation.<sup>51</sup> Although they are unlikely to move the needle much on their own, many of the changes the bank outlined appear to be positive, and by addressing holdout risk, they will encourage greater private sector engagement in debt-restructuring processes.

Whereas the same standardized CAC language that exists in the bond markets has no equivalent in the syndicated loan market, it has become more common in the English syndicated loan market for lending banks to agree that certain “structural adjustments” to credit facilities for corporate borrowers that previously would have required unanimous consent will require only the consent of the majority or a supermajority of lenders.

Such structural adjustment matters typically encompass provisions such as an extension of maturity or of scheduled repayment dates, a reduction in principal or in interest amounts owing under certain loan tranches, or a redenomination of a commitment into another currency. If a sovereign borrower

can negotiate similar “structural adjustment” provisions into its loan documentation, such provisions will provide benefits akin to those of CACs.<sup>52</sup>

Other contractual mechanisms to incentivize lender engagement that are commonly found in the English or New York leveraged loan markets also have been employed in the sovereign loan context. For example, “snooze-you-lose” clauses are commonly included in sovereign syndicated loans in the English loan market requiring lenders to vote on amendments or waivers to loan documentation within a certain number of business days of being notified of the request by the borrower, failing which their vote will not count. So called “yank the bank” or “replacement of lender” provisions are examples of other contractual mechanisms that can be included in syndicated loan documentation to compel private lenders to engage in restructuring discussions, or to provide an effective means to replace dissenting lenders if they hold up otherwise consensual restructurings.

Sovereign debt is the only debt class that relies on contractual mechanisms in lieu of an institutionalized bankruptcy regime.<sup>53</sup> In the absence of such a regime, contractual mechanisms that provide positive and negative incentives that can afford needed breathing room and liquidity relief to a sovereign at times of distress and can mimic some of the most effective features of corporate insolvency processes (such as cram downs of dissenting creditors) are and likely will remain a vital tool in engaging private creditors in sovereign debt restructurings and in enabling more equitable burden sharing with bilateral and official sector creditors.

### *iii. State-Contingent Debt Instruments*

State-contingent debt instruments create a link between a sovereign’s payment obligations and exogenous events that affect (one way or another) the sovereign’s ability to pay. Examples include natural disaster and payment-in-kind clauses, and warrants linked to gross domestic product, commodity prices, or another variable that might serve as a proxy for the sovereign’s ability to pay. Such clauses generally allow for a suspension of principal or interest payments on the occurrence of a covered adverse event and, in some cases, an increase or acceleration of payments on the occurrence of a particularly favorable event. To the extent that these instruments, like the stabilization fund discussed earlier, reduce the likelihood of default and provide more space for the parties to negotiate a consequent consensual restructuring if needed, they may be seen to reduce the risk and increase the attractiveness of investment in sovereign debt.

These instruments are suitable in principle both for new issuances of debt and as instruments to be issued in a restructuring. Moreover, in a restructuring context, if properly designed they may serve as a natural corrective mechanism should a debtor country’s actual performance exceed that assumed in the DSA.

To date, such instruments have not been widely adopted for a variety of reasons, including the difficulty of valuing them, poor design, and concerns



that the outcome could be manipulated by the debtor. In addition, a concern exists that state-contingent debt instruments could reduce incentives for sovereigns to take strong measures that might be appropriate to deal with economic downturns. More generally, however, the IMF has determined that these instruments could offer a valuable means to lower the fixed-debt burdens of emerging market sovereigns, while at the same time providing investors with upside recoveries should sovereign borrowers outperform.<sup>54</sup>

As the Bretton Woods Committee SDWG intends to devote its next paper to an in-depth look at these instruments, discussion here is limited to this summary.

#### *iv. Legislative Action*

Sovereign debt restructurings, like corporate restructurings, take place within, and are informed by, applicable legal frameworks. While the script that any particular restructuring may follow is most often dictated by the relevant contractual documentation, the relevant statutory framework also may have an impact. Thus, when evaluating private sector involvement in sovereign restructurings, it is important to consider the applicable legislative framework and any changes that may be introduced that might enhance or deter private sector engagement.

***National legislation.*** Virtually all external sovereign debt issued by emerging and middle market sovereigns is governed by New York or English law. Consequently, it is the law of those two jurisdictions that matters most in sovereign restructurings. New York and English law are largely similar in all important substantive respects. In each case, although there may be skirmishing over procedural and jurisdictional issues and questions regarding the scope and extent of immunity provided to a foreign state's assets or property, investors can take comfort that the contracts on which they relied at the time of their investment will be strictly enforced. In the absence of a comprehensive bankruptcy regime for sovereigns and their instrumentalities, it is the most an investor can hope for in this context.<sup>55</sup>

In the last several years, however, a growing number of jurisdictions have considered, and in a few cases adopted, various changes to their national laws. These statutory changes generally are driven by one of two objectives: to replicate elements of national insolvency laws, modified to apply to sovereign debtors and their instrumentalities, or to tip the scales in favor of sovereign debtors at the expense of creditors in one form or another.<sup>56</sup>

In the first case, legislators generally seek to impose through legislation a collective action mechanism on sovereign workouts and apply that broadly to all claims (other than from the official sector) against a distressed sovereign. However, such legislation does not generally include the typical procedural and substantive safeguards that creditors normally rely on in most insolvency regimes. In many ways, this type of statutory scheme is eerily reminiscent of

the efforts that accompanied the IMF's ill-fated proposal for the Sovereign Debt Restructuring Mechanism in the early 2000s. In the second case, legislators seek to protect distressed sovereigns by insulating their offshore assets from seizure in certain circumstances.

***Opt-in comprehensive restructuring statute.*** In 2021, the New York state legislature introduced a bill (hereafter, the 2021 NY Bill) that would allow indebted sovereigns to opt into a comprehensive restructuring process for all of their New York law-governed debt.<sup>57</sup> The restructuring process, as originally contemplated, would include a collective action mechanism and be overseen by a supervisory authority designated by New York's Senate Finance Committee. The bill was both comprehensive and ambitious and required a mandatory audit of the financial information of any sovereign that opted into the statutory process. Subsequent to its introduction, various modifications have been made to the 2021 NY Bill, including notably removing the role of the supervisory authority, curtailing the audit obligation, calling for the appointment by the New York state Governor of an independent monitor and seeking to address various legal and practical infirmities that were part of the original bill.<sup>58</sup> As of the adjournment of the New York State Legislature session on June 8, 2023, the draft legislation remains merely a proposal. Although the 2021 NY Bill may be considered in the Fall session, it may not be adopted.<sup>59</sup>

Although the 2021 NY Bill has some interesting features, it is far from clear that any sovereign would ever agree to use it. For one thing, the proposed legislation does not include a stay, so creditors could continue pursuing legal actions. For another, the legislation—once enacted—almost certainly would be challenged on various legal and US Constitutional grounds. Resolution in such cases likely would take years, so it would extend rather than shorten any restructuring process.<sup>60</sup> Finally, it is doubtful distressed sovereigns would welcome subjecting themselves to a foreign court if that court has as broad a mandate as the proposed legislation contemplates.

The legislation is even less likely to be welcomed by private sector creditors, as it would retroactively rewrite the rules governing debt they already had purchased. Additionally, it would permit creditors holding different instruments to have a voice—possibly a controlling voice—in the determination of their recoveries, by aggregating groups of creditors in one class without the substantive and procedural safeguards that normally form part of statutory insolvency processes. The 2021 NY Bill also would not apply to official sector debt or the debt governed by laws other than New York State including the law of the host government and other foreign law-governed debt. For these and other reasons, US state-level opt-in restructuring laws like the 2021 NY Bill would be less likely to enhance private sector engagement in sovereign debt restructurings than to have the opposite effect.

The New York state legislature is considering a new bill that would limit recoveries on sovereign claims to those that the United States could realize it were the holder of those claims and they were the subject of one or more international initiatives in respect of the sovereign debt of the debtor country. We believe legislation along these lines would be problematic for reasons similar to those set forth above.<sup>61</sup>

A recent UK House of Commons International Development Committee report recommended the UK government introduce similar legislation and encouraged UK lawmakers to engage in bilateral talks with New York lawmakers to explore the scope for cooperation in legislative approaches.<sup>62</sup> However, this was rejected by the UK Government in its response to the International Development Committee on May 11, 2023.

***Anti-vulture fund statute.*** The New York legislature also has proposed anti-vulture fund legislation through an amendment to Section 489 of the New York Judiciary Law (the Section 489 Amendment).<sup>63,64</sup> The Section 489 Amendment would prohibit the purchase of financial instruments solely for the purpose of litigation.<sup>65</sup>

While the Section 489 legislation seeks to aid distressed sovereigns by reducing the holdout risks posed by litigious vulture funds, the legislation, as proposed, could have unintended consequences. Section 489 would subject secondary-market participants that refuse to participate in sovereign restructurings to broad discovery if they refuse to participate in a restructuring and to challenge it.

The risk of such exposure could limit liquidity and impair the functioning of secondary trading markets, and thereby raise the cost of capital for all sovereigns. It also minimizes the benefits to distressed sovereigns of having market participants purchase on the secondary market securities at a discounted price (whether or not they initiate litigation as part of their strategy), which increases the likelihood that distressed sovereigns can obtain a real haircut in an eventual restructuring. As with the 2021 NY Bill and the bill that would limit recoveries on sovereign claims, the Section 489 Amendment was not passed as of the adjournment of the New York State Legislature session on June 8, 2023.

With CACs and other mechanisms present in most modern-day bond documentation, it is far from clear whether such legislation is needed, and the legality of the legislation would certainly be litigated if it were to be applied retroactively. Finally, if such legislation were enacted, one could expect market participants to demand that issuers issue new debt under the laws of a state other than New York State.<sup>66</sup>

Legislative solutions, however well intended, are blunt instruments that carry with them the risk of unintended consequences; even changes that seem relatively benign should be approached with caution.<sup>67</sup> Once enacted, legislation is difficult to amend and may risk reducing an investor's appetite (and

increasing the risk premium) for an asset class that has already seen declining flows. Additionally, attempts to tilt the playing field are unlikely to prevail.

Although today New York and English law are the foreign jurisdictions whose laws most frequently govern contractual disputes between sovereigns and their creditors, it wouldn't be surprising or difficult for the market to demand that the law of other jurisdictions (Delaware or Ireland) apply to new or conceivably even existing debt contracts if New York or English law is changed significantly to favor borrowing countries or their creditors.<sup>68</sup> The switching costs to sovereigns (and frankly to England and New York) alone of having to modify their existing contractual arrangements based on market demands is reason enough to be cautious about statutory changes that seek to do too much at once. Even though the legislative framework that applies to sovereign defaults is far from perfect, caution is appropriate when it comes to making material legislative changes.

Sovereign debt is a complex global market involving constituents from civil society, business, government, as well as debtor nations themselves. Issues like those addressed by these bills are more appropriately discussed and debated in international forums, like the G20 Global Sovereign Debt Roundtable, where all these voices are represented. The sovereign debt market, particularly in a restructuring context, relies on the roles and processes undertaken by bodies such as the IMF and Paris Club, among others. It is critical that there is also discussion with these bodies so that a consensus can be reached as to how any proposed restructuring mechanic will work in tandem with the processes that are currently a key part of the sovereign restructuring landscape.

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**Legislative solutions, however well intended, are blunt instruments that carry with them the risk of unintended consequences.**

#### *v. Other Legislative Possibilities*

Notwithstanding the foregoing remarks, it appears that there could be merit in considering legislative changes to implement an agreed-upon restructuring that seek to address specific gaps in the law related to protecting sovereign assets once a consensual restructuring has been agreed. Although only a few countries have considered or adopted these sorts of discrete protections, they likely would be welcomed by the private sector, particularly if they apply to restructuring processes that are pursued in good faith, have received the support of a supermajority of creditors, and, ideally, can be used to commit the relevant sovereign to improve transparency and good governance going forward.<sup>69</sup> As a result, this type of legislative solution would offer a better alternative to dealing with litigious holdout creditors than the anti-vulture fund statutes that we have just discussed.

One legislative solution that may be worth considering relates not to sovereign defaults but to defaults of state-owned enterprises (SOEs) such as oil and gas and other natural resource companies, particularly those with assets or operations outside the host country that are more vulnerable to attachment

or operational disruption than sovereigns. Such state-owned companies frequently generate a substantial share of a sovereign's foreign reserves and may be critical to a sovereign's ability to service its own external debts. If such entities fall into financial distress the sovereign usually has little choice but to provide financial support (often negatively affecting its own financial position) in part because of the existing vulnerabilities even if a debt restructuring at the instrumentality level would make more sense. In such circumstances, sovereigns and their creditors might both be better off if there were legislative means to adjust the debt of such entities, which primarily are commercial enterprises, in a fair and equitable manner.

Two legislative options are available that could help sovereigns and their instrumentalities deal with these circumstances. The first option entails the adoption by sovereigns of a local reorganization statute that is specifically designed for distressed public sector entities. It would be useful to have an agreed model law for such purposes that states could adopt. Whatever model is used, the law of any particular jurisdiction would have to take into account the local circumstances that apply in such jurisdiction.<sup>70,71</sup>

One model for such a local public sector reorganization law is found in Chapter 9 of the US Bankruptcy Code,<sup>72</sup> but there are other models that could be helpful as well. These local reorganization laws generally permit the SOE to continue to operate and provide essential services while it seeks to reorganize and provide a stay against creditor action. They also include collective action mechanisms that allow the public sector debtor to bind holdout creditors if a supermajority of creditors approves a plan.

Importantly, in order to have these proceedings and the resulting plans recognized and enforced in jurisdictions outside the host country, the proceedings and the resulting plan must meet certain minimum standards that protect creditors against abuse. Such safeguards allow creditors to challenge a plan if due process is not observed or their fundamental rights are violated and gives them access to courts in the developing world, as well as locally, to ensure that they have a fair hearing on those issues.<sup>73</sup>

This approach has worked well in the private sector context when corporate debtors have sought to have their reorganization plans approved and enforced across borders and outside their home jurisdiction pursuant to the UNCITRAL Model Law on Cross-Border Insolvency. This same mechanism could be used to ensure that a proceeding and plan involving the reorganization of a local government instrumentality meet these minimum requirements.<sup>74</sup>

A second legislative alternative to manage the potential default of a sovereign instrumentality is to employ an English law scheme of arrangement (a "scheme") that has proven to be an effective mechanism to aid in the restructuring of corporate debt outside a formal bankruptcy process.<sup>75</sup> Such a scheme permits contractual arrangements between debtors and their creditors to be

modified based on the collective action of a supermajority of the debtor’s creditors (75 percent of the class by value and a majority in number) and has been used frequently in cases involving unsecured bond as well as nonbond debt.<sup>76</sup>

An English court has jurisdiction to sanction the scheme if the debt is sufficiently connected to England. In practice, this requires either that the relevant agreement is an English law–governed contract or that other sufficient connections to England exist. English courts have sanctioned schemes when the governing law of the underlying contract has been changed to English law immediately prior to and in anticipation of employing a scheme to bind minority holders.

Interestingly, examples exist of SOEs successfully using schemes to restructure their debt. Moreover, there is now also a possibility, through the introduction of the “super scheme” for companies in financial distress, to cram down dissenting classes of creditors through the “cross-class cram-down” feature.<sup>77</sup>

Finally, a third legislative idea that may facilitate more efficient and durable outcomes when it comes to sovereign restructurings and that would be welcomed by the private sector as much as it would be by distressed sovereigns is the enactment of legislation at the national or supranational level that provides incentives for private sector engagement in sovereign restructurings. The concept is simple enough to describe though the formulation and implementation would no doubt be complicated.

In effect the legislation would provide that creditors that “participate” in and “contribute” to a distressed sovereign’s restructuring would earn financial incentives for doing so. These “earned credits”<sup>78</sup> would be tradeable and could be styled as credits against income or capital taxes or convey some form of regulatory relief (such as carbon offsets, etc.). A lender could earn these credits in exchange for the extraordinary financial assistance it provides to a struggling sovereign (in the form of below-market interest rates or other debt relief beyond what would otherwise be achievable in a purely commercial setting).<sup>79,80</sup> Synthetic assets of this sort have, of course, been designed and are in use in other contexts (such as carbon and tax credits).

Providing incentives, rather than disincentives, to encourage greater private sector participation is not typically the way sovereign commentators think about legislation aimed at assisting distressed sovereigns, but it is worth further exploration and has been used quite successfully in other contexts. The US municipal finance market, including state, city, and municipal issuers, as well as SOEs charged with developing and operating key infrastructure assets, have relied for decades on tax incentives to promote greater investment and broaden their investment pool.

#### *vi. Supranational Legislative Actions*

In 2002 and 2003, the official sector, led by the IMF, made an intensive, but unsuccessful, effort to garner support to amend the Articles of the IMF

in order to create a legal framework for sovereign debt restructuring known as the Sovereign Debt Restructuring Mechanism. Despite much effort, the undertaking failed to attract support from the United States, debtor countries, private creditors, and indeed parts of the official sector.<sup>81</sup> One of the fatal design issues for which no acceptable solution was found was who would play the role of the ultimate arbiter. In the absence of a truly independent judicial body that could play that role, the IMF, not surprisingly, looked to itself, despite its conflicting roles in the restructuring process. Also, not surprisingly, neither debtors nor creditors were comfortable with that result.

Since that time, for the most part, efforts at the international or supranational level to address the challenge of managing sovereign defaults have focused largely on attempts to forge a consensus among key stakeholders regarding basic principles while leaving any particular sovereign default to be navigated based on the facts and circumstances of a given situation. The Common Framework, the DSSI, the updated IIF Principles, and the Organisation for Economic Co-operation and Development's (OECD's) efforts to act as a repository for data and information on sovereign finance all form part of the international financial architecture intended to create a framework for sovereign liability management.

There have been a few isolated attempts to use supranational legal measures to protect struggling sovereigns, but those have been exceedingly rare and limited to very unusual circumstances.<sup>82</sup> One such example is the United Nations Security Council resolution in 2003 protecting Iraq's oil assets from creditor attack and mandating member countries to adopt implementing legislation to that effect. Similar arrangements are unlikely to become a blueprint for future sovereign debt challenges—nor, in our view, should they. Even the IMF has described such an approach as the sort of option available “as a last resort,” while warning against overuse.<sup>83</sup>

### III. EQUITABLE BURDEN SHARING

#### A. The Issues

The issue of burden sharing and equitable participation in a sovereign debt restructuring goes to the essence of private creditors' investment decision making. Because sovereigns are not subject to national bankruptcy laws<sup>84</sup> and there is no applicable supranational or international insolvency regime, private investors do not enjoy the typical protections afforded investors if a debtor defaults, including protection against a debtor or a group of creditors seeking to discriminate against them in designing an adjustment plan or in allocating the burden of that plan among creditors.

The risk of unfair and inequitable treatment is compounded because it is well understood by the debtor and other creditors that the debtor's domestic courts, and even foreign courts, are difficult venues when it comes to actual

enforcement of claims against sovereigns.<sup>85</sup> Further, as discussed below, because the contribution to restructuring of official creditors is determined prior to that of private sector creditors, the IMF and other official and bilateral creditors<sup>86</sup> frequently play an outsized role in determining the contribution of private sector creditors as a class. This is true even though private creditors may hold a substantial portion of the outstanding debt, and even though the public creditors assiduously avoid intervening to ensure comparable treatment of individual private creditors. Parenthetically, this public/private sequencing is embodied expressly in the Common Framework.

Consequently, a would-be private lender to a sovereign borrower must decide whether it is prepared to assume and manage the incremental risk of fair treatment (compared to a lender to a private sector borrower) and the restricted ability to enforce its contractual rights, and whether the financial terms of the credit adequately compensate it for that risk. Finding a way to mitigate that risk would have the salutary effect of encouraging increased private sector inflows, lowering the cost of borrowing for poor and middle-income sovereign borrowers, and facilitating a consensual and (relatively speaking) streamlined workout process.

Burden sharing and comparable treatment play out on three levels: among official creditors (where the principal issue is reconciling China's approach to that of the majority of other official bilateral creditors—a topic that is outside the scope of this paper but nonetheless highly germane to the treatment of private creditors); between private and official creditors; and among private creditors themselves.

This paper focuses on the second of these issues—the significant divide that exists between private and official creditors on the issue of burden sharing and comparable treatment. As between private creditors, there is an abundance of precedent and experience. Moreover, in the sovereign context, the issues among private creditors may be easier to resolve if progress on the issues between private and public funding sources can be made.<sup>87</sup>

As between private and official creditors, burden sharing and comparable treatment can be broadly understood in two categories: what relief is needed and how that relief is apportioned between official and private creditors.

The first category starts with the quantum of relief needed, but also includes choices as to where that relief is to come from, including these:

- What debt needs to be treated? Should we treat only selected maturities, domestic as well as external debt, trade finance, short-term debt, secured debt, project debt, etc.?
- What debt should be excluded from the restructuring? Do we include certain of the categories referred to above as well as debt owed to MDBs?

As is evident, some of the choices highlighted above implicate the relative contributions of different groups of creditors.



The second category is the essence of burden sharing: Who contributes how much?

The Common Framework is the latest attempt by the official sector to embed equitable principles of burden sharing and inclusiveness in the international financial architecture.<sup>88</sup> This effort, although well intentioned, has proven inadequate for the purpose. Although it has been more than two years since its introduction, to date only four countries have requested relief under the program, and not one has concluded a restructuring.<sup>89</sup> Nonetheless, this is the framework that the official sector is promoting as the way forward.

The analysis and observations that follow begin with a definitional inquiry—what is equitable treatment and what are its objectives?—and then examines how well the Common Framework respects this definition and whether its design is in fact suitable to further these objectives.

## **B. What Is Meant by Equitable Burden Sharing or Comparability of Treatment?**

Similar to the observations contained in the Bretton Woods Committee's prior paper on transparency,<sup>90</sup> this question has both a procedural and a substantive dimension. Procedurally, fairness requires at a minimum that different stakeholders have the same information and an opportunity to participate in the process of determining the quantum, nature, and apportionment of relief, if not to control it or even have a formal vote.

Substantively, the question of equitable burden sharing is a highly complex exercise. It is not simply a question, as some would have it, of comparing the net present value of debt reduction granted by different creditors or creditor groups (which itself is not without controversy).<sup>91</sup> Excluding certain debts from the general restructuring and leaving them untouched itself implicates equitable burden sharing. Although public officials may have a preconceived view that certain debts merit or require treatment different from that accorded unsecured bonds or bank loans, or that official sector lenders should be treated differently from others by virtue of their mission, status, or regulatory regime, that view has consequences when it comes to burden sharing.

In broad terms, comparability of treatment requires that the burden of providing relief not be skewed in favor of one creditor or group of creditors, that the process of arriving at debt restructuring solutions is fair and transparent, and that outcomes are determined by good faith negotiations based on the circumstances at the time. In the end, it is the acceptance of these principles by stakeholders that determines whether the process and the outcome are fair.

It is instructive to examine how the Common Framework and predecessor official sector programs sought to define what is equitable or comparable. It can be asserted that—with rare exceptions—there is no mathematical or objective formula that provides an answer that will satisfy all stakeholders. There are

too many competing subjective considerations that cannot be reconciled by reference to purely objective principles.

This limitation notwithstanding, with the combination of a cooperative approach and a much better understanding of the roles, constraints, and objectives of the different stakeholders, market participants likely could coalesce around certain core principles that would lead to a less contentious and more efficient process. Were that achieved, more stable outcomes would result, producing greater confidence that the risks of sovereign lending can be managed successfully.

### C. How Does the Common Framework Approach the Quantum, Nature, and Apportionment of Relief?

The Common Framework is in the first instance a framework to broaden and coordinate official creditor participation in sovereign debt restructurings.<sup>92</sup>

According to the G20's statement on the Common Framework, participating official creditors include "all G20 and Paris club creditors . . . and any other *willing* official bilateral creditor [emphasis added]." Multilateral development banks are not included as creditors per se but are expected to "develop options for how best to help meet the longer-term financing needs of developing countries."

The G20's statement goes on to say that participating official creditors

will coordinate their engagement with the debtor country and finalize jointly the key parameters of the debt treatment consistent with their national laws and internal procedures . . .

The key parameters will include at least (i) the changes in nominal debt service over the IMF program period; (ii) where applicable, the debt reduction in net present value terms; and (iii) the extension of the duration of the treated claims . . . The key parameters will be established *to ensure fair burden sharing among all official bilateral creditors, and debt treatment by private creditors at least as favorable as that provided by official bilateral creditors* [emphasis added].<sup>93</sup>

With the role of official creditors thus defined, the next consideration is that of the role of the IMF in determining the quantum of relief to be provided to the sovereign debtor as well as the role of the IMF and other official creditors in determining the nature and apportionment of that relief.

Among the critical initial steps in a sovereign restructuring under the Common Framework are the determinations of the restructuring envelope (which defines the financing gap that needs to be closed through a combination of restructuring and new money [loans or grants]) and, subsequently, the contribution of the IMF—which is in the form of new financing.<sup>94</sup> The IMF/

World Bank DSA and the “collective assessment” of the official creditor are the basis for the former. As a formal matter, private creditors have no role in this process either as observers or as decision makers.

Understandably, the IMF maintains complete discretion as to the size of its financial contribution to a restructuring.<sup>95</sup> Although it is neither envisaged nor advocated that the IMF abdicate its responsibility and prerogative ultimately to determine a country’s debt sustainability profile, greater transparency as to the assumptions underlying that determination as well as a willingness to consider openly the views of other creditors, including in particular the private sector, would go a long way to building confidence in the restructuring process and the fairness of the IMF’s determinations.

Obviously, enhanced private sector confidence in this crucial calculation in turn would enhance private participation in restructuring (not to mention new lending). Private sector input should come directly from the creditors of the debtor (most likely acting through a creditors’ committee, and not from a surrogate) as they not only have a stake in the outcome but also, if the process is well done, likely are providers of future funding.

From a procedural standpoint, private creditors typically view the process at present as skewed against their interests, regardless of the scale of their stake. The IMF, of course, is the only lender of last resort with the role and capacity to provide very substantial funding to a sovereign debtor in distress, but given its status as an existing or soon-to-be creditor, many private lenders are uncertain whether it can be considered to be neutral in the process.

Moreover, under the Common Framework, participation in a restructuring by non-Paris Club, non-G20 official bilateral creditors as well as by MDBs, whose claims may represent a substantial portion of the debtor’s liabilities, is explicitly made voluntary. Add to this the prescriptive but essentially content-free requirement that the debtor provide to its creditors “the necessary information regarding all public sector financial commitments (debt), while respecting commercially sensitive information”<sup>96</sup> and it is no wonder that even before addressing the core issue of comparability of treatment, private creditors feel that they effectively are participating in a process in which they have incomplete information and limited control.

The only instruction as to the contribution of private creditors is that “debt treatment by private creditors [be] at least as favorable as that provided by official bilateral creditors.” Of course, these characteristics do not differ from those that governed debt restructuring previously under the Paris Club.

Thus, an initiative designed to expand the role of official bilateral creditors in order to encourage their engagement did not at the same time enhance the incentives for private creditor participation. The failure to enhance private creditors’ engagement in the development of restructuring proposals, if left unchanged, may prove to be an impediment to expanding private sector lending to sovereign borrowers.<sup>97</sup>

In this regard, it is worth mentioning that the original G20 statement announcing the Common Framework on November 13, 2020, provided for a cutoff date of March 24, 2020—meaning that debt contracted after that date would not be taken into account for purposes of determining debt sustainability and, therefore, would presumably be exempt from the current restructuring. That is the same cutoff date initially set for purposes of the DSSI in April 2020, but it is questionable whether that date should remain permanently fixed.

That said, if private lenders are to be encouraged to continue to lend to emerging market sovereign borrowers, they need to know if their new debt is liable to be swept up in the current restructuring. Thus, it would make sense for the cutoff date in each case to be fixed either at the date on which a country applies for relief under the Common Framework or at a date some prescribed period before then.

The sparse text of the G20's statement on the Common Framework also does not provide guidance as to how debt relief is to be fashioned. That is, it does not specify exactly which debts are to be treated, or how. It only specifies that eligible debt includes “all public and publicly guaranteed debts which have an original maturity of more than one year.” In practice, however, sovereign restructurings are rarely, if ever, that inclusive. In the absence of a compulsory legal framework, there is no alternative to intercreditor negotiation.

***Burden sharing.*** There is neither authority nor consensus as to what constitutes equitable burden sharing or comparability of treatment. What precedents exist in the sovereign arena are of limited scope and utility, but it is nonetheless instructive to keep them in mind.

Both the HIPC Initiatives I and II and Paris Club restructurings of bilateral debt include requirements that a debtor country seek comparable treatment from non-Paris Club bilateral lenders and private creditors. This same approach is continued in the Common Framework, where the concept of comparable treatment is not defined per se but limned obliquely by reference to changes in nominal debt service, net present value of debt, and duration—with the added fillip that any determination is subject to mitigating factors.

Determination of comparable treatment under these programs has been marked by a large element of ad hoc decision making. These precedents do little to illuminate how restructurings under the Common Framework should apportion debt relief, particularly in today's environment, where the variety of credits and creditors far exceeds those of the past.

As a result, the Common Framework does not confront the most difficult issues underlying the notion of equitable burden sharing. For its part, the IMF is concerned first and foremost that the aggregate amount of financing from all sources is sufficient to support the debtor's IMF economic stabilization program, and in a first approximation is agnostic as to where the money or

debt relief comes from. Indeed, apart from specifying that “the key parameters will be established so as to ensure fair burden sharing among all official bilateral creditors,” it avoids focusing on the contributions of a particular class of private creditors, much less that of any individual private creditor. As the position of the IMF and the Paris Club is to look at the relief agreed by a class or subclass of creditors (the private sector, for example, or perhaps bondholders), the process invites individual creditors to seek the best treatment for themselves that they deem possible.<sup>98, 99</sup>

***The Chinese conundrum.*** Following the Global Financial Crisis, China has become the largest single lender to developing countries.<sup>100</sup> At the same time, it has carved out a distinctly different path from other official (and private) creditors. Chinese banks’ lending arrangements often incorporate terms that differ in several important respects from those followed by Western bilateral lending institutions, and they heretofore have eschewed creditor coordination in favor of often undisclosed case-by-case bilateral loan modifications. Additionally, they are at best reluctant adherents to a policy of increased transparency.<sup>101</sup> Against this background, the Common Framework was designed in large part to try to find a way to align China’s practices with those of the G20 and the Paris Club.

There is evidence on the ground that this effort is floundering. China insists that of its large state-owned lenders, only the Export-Import Bank of China is an official creditor and its largest lender, the China Development Bank, is a commercial creditor.<sup>102</sup> Thus, China’s position is that most of its sovereign lending activity is not subject to the Common Framework. This would allow the China Development Bank, for example, to argue for better terms from its debtors based on undisclosed contract provisions that create incentives for sovereign borrowers to accept less-favorable terms than from other creditors.

Additionally, China has manifested a strong preference for new lending or reprofiling as opposed to debt stock reduction with a view to maintaining the nominal value of its claims. Indeed, Chinese officials have complained that the MDBs’ refusal to grant equivalent debt relief to that sought from bilateral lenders is inconsistent with equitable burden sharing.

Of course, to the extent that Chinese loans are not made to governments for general purposes but rather to support particular projects and investments, their approach may be understood as an effort to tailor debt relief to the particular circumstances of different debtors; to that extent, the position of Chinese banks is not dissimilar to that of private sector creditors and thus is consistent with China’s view that much of their lending should be considered “commercial.”

As a result, a more consensual approach—one that doesn’t start with the proposition that the Common Framework and Paris Club are the only options—could be a productive exercise. In this context, the formation of the Global Sovereign Debt Roundtable could provide a productive starting point

for potential progress. The group includes a relatively small working group from the official and private sectors, including highly regarded experts with practical experience—a practical approach to equitable burden sharing.

This analysis suggests that the restructuring process contemplated by the Common Framework could and hopefully will be improved, and outcomes broadly acceptable to all stakeholders could be reached more readily in specific country cases. Potential improvements include these:

- (1) *Expanded inclusion of private creditors as providers of financial resources and participants in the restructuring process.* It is critical at the onset of any restructuring process that all stakeholders have the opportunity to contribute to the design of the liability management exercise. An inclusive approach such as this will not only ease the task of arriving at a sensible resolution of a debt crisis but also materially improve the attractiveness of investing in sovereign debt by moderating the perception of risk that such an investment entails.
- (2) *Enhanced access to information.* No shared understanding of what is required to satisfy the requirement of equitable burden sharing will be of practical use unless all creditors have access to pertinent information regarding claims against the debtor, including relevant provisions of nondebt documents, such as an ancillary agreement that essentially modifies the terms of debt reflected in the debt documents.<sup>103</sup>
- (3) *Expanding the universe of participating official creditors.* G20 and Paris Club bilateral creditors are expected to participate in a Common Framework restructuring based on “fair burden sharing” among them, except that “due consideration shall be given to [their] specific concerns.” The Common Framework implicitly weakens the incentive of non-Paris Club, non-G20 official creditors to participate in a restructuring by including them only if they are “willing” to participate. Similarly, it effectively gives a free pass to MDBs that want out—they merely are invited to “develop options for how best to help meet the longer-term financing needs of developing countries . . . while protecting their current ratings and low cost of funding.”<sup>104</sup>

The question of what distinguishes some creditors from others and the extent to which such distinctions may or may not justify different treatment in a restructuring will be addressed subsequently. However, MDBs are not the only institutions that are sensitive to their credit rating and their cost of funding. Carving out special treatment for some official creditors clearly invites private creditors with their own “specific concerns” and funding constraints to exercise their self-accorded entitlement to similar treatment. Thus, MDBs should find ways to contribute financial relief in one way or another.

- (4) *Included and excluded debt.* The debt of a sovereign debtor and its guaranteed SOEs might include unsecured and secured bank loans, bonds, loans to SOEs with positive cash flow, a myriad of hybrid instruments (some with

both debt and equity-like characteristics), project finance, derivative exposure, cofinancing and A/B loans with both official and private creditor exposure, domestic currency loans and bonds, and debt-like claims that are characterized as something else, such as the obligation to deliver a commodity in consideration for a large up-front “prepayment.” Independent of how they are treated in a restructuring is the question of whether some of these obligations ought simply to be excluded from a restructuring or treated separately (and more favorably) outside of the restructuring.

The decision to exclude some credits or classes of credits is, of course, germane to burden sharing, among other things. In practice, short-term debt, trade finance debt, domestic currency debt, derivative exposure (except, notably, in the cases of Korea and Indonesia), project finance debt, and lending to SOEs that are current on their payments and able to service their debts, have often been excluded or treated outside the general restructuring, particularly when the amount in question is relatively small in comparison to the total debt to be restructured.

Except for the treatment of domestic currency debt, which can be highly contentious, the decisions to exclude certain categories of debt have not proven particularly controversial and are best left to ad hoc agreement among the debtor and its creditors. In the case of local currency debt, one consideration, apart from the relative size of internal debt, is the extent of nonresident holdings. It would seem odd for foreign investment in domestic currency instruments automatically to be granted seniority over foreign investment in external debt. It would be particularly unwise to grant different treatment to the same debt based on the nationality or nature of the creditor. Thus, domestic banks and other financial institutions, as well as individual citizens of a debtor country, may be significant holders of external debt but have uniformly been treated equally despite the obvious potential impact on the debtor’s financial system and the political ramifications.<sup>105</sup>

(5) *Same debt, same treatment? Different debt, different treatment?* It is tempting to say that this is an easy question: comparable debts—say, general unsecured extensions of credit (whether in the form of bonds or bank loans)—should be treated alike. And, as some commentators, advisers, and participants have argued, a single metric—net present value—is a tested and generally acceptable approach. Its appeal, among other things, is that it enables both the official sector and the private sector to say they are not bailing out the other.<sup>106</sup> Unfortunately precedent and expectations suggest that the question is not that simple.<sup>107</sup>

The example of US bankruptcy law, as well as that of single-limb CACs referred to previously, would argue that all similarly situated creditors should receive identical treatment, meaning that the terms of each creditor’s debt

post-restructuring (or the options offered to each of them) should be identical, which is quite different from equalizing net present value.

Identical treatment can have decidedly unequal consequences. It may, for example, result in lengthening the duration of shorter-term debt and reducing the duration of longer-term debt—as was the case in the Ukraine restructuring.<sup>108</sup> The theoretical justification for this approach is that the restructuring puts all debt in default and immediately due and payable, so the original maturity and other terms are irrelevant.

Moreover, private creditors with more favorable documentation may insist, as they did successfully in Ecuador's 2020 restructuring, that their debt be restructured on more favorable terms than other debt, which then throws a wrench into the creation of parity between the official and private sectors. Additionally, it remains to be seen whether bank lenders, whose loan agreements generally follow a different pattern from bonds, will accept as a principle that their loans should be treated in the same way as bonds in all circumstances.

As noted, the universe of sovereign credits has become increasingly diverse. In some cases, it may be relatively easy to distinguish between credits—secured versus unsecured debt or senior versus subordinated debt, for example. But in others it may not be clear where to draw the distinction or, once the line is drawn, how different creditors should be treated in the spirit of comparable treatment.<sup>109</sup>

In Greece's government bond restructuring, for example, government-guaranteed credits to SOEs were excluded from restructuring if the SOE was current in its payments and there had been no recourse to the government guarantee. That would seem to make sense, but it is not clear that that treatment is consistent with the Common Framework. Similarly, should a decision be made in a particular case to treat domestic as well as external debt, there is little precedent today as to how, if at all, treatment of the former should factor into the discussion of equitable burden sharing.

A further question arises if a private creditor chooses to make new loans (much as the World Bank and other MDBs often do) rather than compromise its existing claims. How is the provision of new money to be compared to debt reduction or other modifications of debt terms? In the case of the restructuring of private sector debtors, creditors that provide new money are sometimes able to obtain preferential treatment of their existing claims.<sup>110</sup>

It may be that over time, consensus will develop as to how at least some of these questions should be addressed, or at least as to a set of general guiding principles. However, that point clearly has not yet been reached, even with the simplest issue of how to determine equivalent net present value reduction.<sup>111</sup>

What is not likely to work is an effort by official sector institutions to take it on themselves to promulgate these principles, much less to provide concrete answers to the questions identified above—first, because the neutrality of the official sector (including the IMF) is not completely convincing to private lenders, reflecting its status as a creditor; second, because a case-by-case



approach is the most likely path to forming consensus; and third, because the official sector thus far has adopted an agnostic attitude toward the apportionment of debt relief. Thus, a change to a top-down approach will almost surely prove problematic, further exacerbating rather than narrowing the existing divide between the official and private sectors.

To the extent that the official sector prioritizes the mobilization of private capital and, as part of that effort, expands the use of blended capital techniques, issues of comparability of treatment as between official and private creditors may be easier to resolve.

***Should the nature, status, or special concerns of a creditor affect its treatment in a restructuring?***

The Common Framework explicitly recognizes that different official creditors may be entitled to special treatment. Thus, the “specific concerns” of official bilateral creditors, the fact that the MDBs covet their credit rating to maintain low borrowing costs, and the willingness of non-Paris Club, non-G20 bilateral creditors to jointly provide relief of any kind all are cited as legitimate bases for variance from the comparable treatment applicable to other official bilateral creditors. This is largely an intracreditor issue for official creditors. But it becomes an issue of equitable burden sharing if, for example, official creditors that are offered a free pass or especially favorable treatment represent a significant portion of the debtor’s external debt that otherwise would be restructured and the relief that otherwise would have been expected of them is shifted to the private sector.

The distinctions among official creditors that the Common Framework recognizes reflect legitimate considerations that cannot be dismissed out of hand. The relevant question in the current context is, why limit this recognition to official creditors? If access to private international financial markets is to be broadened, one can make a strong argument for taking the same approach with private creditors. If the added complexity is outweighed by incremental capital flows, the effort likely would be worthwhile.

The notion that unless private or official creditors suffer the same burden of debt relief in mathematical terms, such as net present value, one or the other is subsidizing the other is not convincing. If an official bilateral creditor is not responsive to market pricing in the same way as private creditors, and does not have to mark to market the carrying value of its loans, does that suggest that it should be more generous than private creditors? Similarly, does their mission—for example, export promotion—also suggest the same?

Can it be argued that official creditors that receive preferred creditor status (an informal arrogation of seniority not reflected in credit documentation and formally inconsistent with the negative pledge clauses present in virtually all private loans and bonds) can afford to be more generous in mathematical terms than their private counterparts and still be considered to provide comparable relief?

Official creditors do not tie *new* lending to parallel lending by the private sector and in general they lend for reasons different from those motivating private creditors, so why should the terms of debt relief be similar? Should all creditors be required to share a part of the burden attributable to creditors that overlend (however that may be defined)?

The general question of whether it is appropriate to treat lenders to sovereign borrowers differently based on their ownership, mission, or regulatory status is worthy of serious and thoughtful discussion, which to date it has not received. These questions are not susceptible to generalized answers applicable in all cases, but they are germane to the question of comparable treatment.

It is fine to leave important elements of a restructuring to be worked out among the parties. That is the essence of a case-by-case approach, which most stakeholders prefer to the alternative. That said, an *ex ante* understanding of and commitment to clearly defined principles (if not precise mathematical formulae) as to what constitutes comparable treatment and fair burden sharing—in effect, simple and fair rules—would encourage both flows to sovereign borrowers and participation in sovereign restructurings when necessary.

We have highlighted the fundamental issues to be addressed in considering the question of comparable treatment. Although not discussed here, there are a number of discrete technical issues that are likely to require resolution in future restructurings.<sup>112</sup>

## IV. CONCLUSION

With a bit of perspective, it is apparent that we are now in a situation where despite the growing number of sovereign borrowers in or at high risk of severe distress, including borrowers with substantial obligations to both the official and private sectors, the practices, policies, and institutions that make up the international financial architecture, including the Common Framework, are rightly being questioned by all sides. What is needed, and what we do not have, is consensus among official and private market participants as to their roles and responsibilities in maintaining adequate funding to allow sovereign borrowers to realize their potential for growth or, if in distress, to cope with the risks of insolvency and consequent threats to economic growth and, indeed, financial stability.

We take as a given that a shared objective is to increase the flow of capital to countries in need. This paper focuses on increasing the flow of private capital, which is incontestably needed. To do so, we propose a fresh look at the existing international architecture and a willingness to go beyond small incremental steps to make improvements where needed. Reconceptualizing the role of the official sector in the manner described in this paper should facilitate debt relief efforts as interests among official and private sector creditors will be more aligned.

The paper discusses several models for cooperation between the public and private sectors that we believe provide useful examples of the benefits of risk sharing. Public-private partnerships and other forms of credit enhancement such as partial guarantees and A/B cofinancings, which extend preferred creditor status to private actors alongside official ones, provide important examples of how risk can be allocated between parties. Tapping the resources of the ESG community in a purposeful way so that low-cost funding can be used to promote improved outcomes over the long term is another. Developing such cooperative initiatives can further bring together the official and private sectors in a manner that can support both sides' objectives, whilst hopefully leading to increased capital flows and more effective restructuring efforts.

As discussed, contractual improvements, market-based initiatives, and, potentially, national legislation also have a role to play in improving the current architecture. Regarding burden sharing, we need to develop a strong shared view of the roles of the official and private sectors in providing funding to sovereign debtors and relief, if needed. There is currently little consensus on or understanding of the roles and objectives of the private and public sectors, or the constraints each face. Consensus must be reached on those questions first, before an agreement can be reached on principles of comparable treatment.

And then there is the issue of China. The inability to reach a common understanding with China has affected progress in reaching an agreed-upon common framework. While there is little doubt that China's preference for bilateral negotiations with debtors in distress is intended to enable it to reach a better outcome than it believes would be achievable with a common approach as well as to reflect the different circumstances of different borrowers, it does not follow that a consensus on how to manage debt relief cannot be found. The recent agreement on a common position between China and the other members of Zambia's official creditors committee (followed by agreement between Zambia and the committee) is a positive development in this regard, although the details of the agreement have not as yet been made public.

It is gratifying to note that the conclusions of the recent Paris Forum and Paris Summit are in line with the main themes of this paper as regards the critical need to expand private sector funding to vulnerable countries, and the importance of derisking in achieving this goal. That said, the Paris Summit did not propose specific measures to attract substantially more private capital to address the climate, nature and development needs that had been identified, nor the means by which this could be accomplished.

The tasks proposed in this report are ambitious. However, they have the potential—if they are developed and implemented—to enhance substantially both the flow of private capital to countries in need of financing, as well as the efficiency and effectiveness of sovereign debt restructuring. They merit, therefore, careful and serious consideration by both policymakers and financial market participants.

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**We need to develop a strong shared view of the roles of the official and private sectors in providing funding to sovereign debtors and relief.**

## ENDNOTES

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- 9 Because most such large asset managers measure their performance against certain well-known indexes, their ability to modify their portfolio holdings in the face of change is more limited than they would like even when their own analysis suggests they should be taking bolder action. Although the role such indexes play in the world of sovereign finance is beyond the scope of this paper, it is an area worth exploring further when it comes to examining the question of whether private capital can be leveraged more in these markets.
- 10 Although beyond the scope of this paper, one area that calls out for greater attention is the interplay between the internal capital and other bank policies that require banks to suspend or curtail credit to stressed sovereigns and the official sector’s efforts to provide debt relief to struggling sovereigns. Aligning the requirements of these internal policies and the regulatory overlay for these institutions so they fit with the efforts of the official sector is a topic worthy of further investigation.
- 11 On the other hand, bondholders formed competing committees in the recent Argentine restructuring that complicated and delayed reaching final agreement.

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  - 34 Rollups of existing defaulted secured debt increase the priority of a rescue lender’s debt to super-priority debt by allowing rolled-up debt to get repaid at the same time as rescue debt, which is almost always ahead of preexisting debt. Because the lender that benefits from the rollup is allowed to essentially elevate a portion of its preexisting debt, it is effectively jumping ahead of other preexisting creditors, at least with respect to the rolled-up debt. The prospect of increased priority could be an attractive lure for private sector lenders that hold sovereign debt to actively participate in restructurings. Rollups serve the double benefit of not only providing a better guarantee of future repayment for lenders but also encouraging participation in restructurings to the benefit of the borrower.
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- 60 For example, the retroactive effect of the law on existing contractual relationships pursuant to sovereign bonds may be unconstitutional under the contract clause of the US Constitution. See, for example, U.S. Const. art. 1 § 10, cl. 1; *Keystone Bituminous Coal Ass'n v. DeBenedictis*, 480 U.S. 470, 503 (1987). The law could also be challenged as an unconstitutional taking in violation of the Fifth and Fourteenth Amendments of the US Constitution, because of government intrusion impacting creditors' property rights. See, for example, *Penn Centr. Transp. Co. v. New York City*, 438 U.S. 104, 124 (1978). Moreover, state legislation of sovereign debt restructuring may infringe on federal foreign affairs powers. See *United States v. Pink*, 315 U.S. 203, 232 (1942) ("If state laws and policies did not yield before the exercise of the external powers of the United States, then our foreign policy might be thwarted. These are delicate matters.").
- 61 New York Senate Bill S4747.
- 62 The report recommended that the UK government consult on the introduction of legislation to compel or incentivize participation of private creditors in the Common Framework, such as that proposed by the World Bank. This should include proposals either (a) to prevent low-income countries facing debt distress from being sued by private creditors for a sum greater than that those creditors would have received had they participated in the Common Framework or (b) to make debt restructuring agreements binding for all private creditors, if the agreement is supported by at least two-thirds of private creditors. See House of Commons International Development Committee, *Debt Relief in Low-Income Countries: Seventh Report of Session 2022–23* (London: House of Commons, International Development Committee, 2023), <https://committees.parliament.uk/publications/34319/documents/189389/default/>.
- 63 New York State Assembly Bill A9317, § 1(4). The United Kingdom and Belgium have passed laws that protect sovereign borrowers from vulture funds by limiting creditor recoveries. See Debt Relief (Developing Countries) Act 2010; see also Code Judiciaire/Gerechtig Wetboek art. 1412.
- 64 New York Communities for Change, "Campaigns—Sovereign Debt," last accessed February 16, 2023, <https://www.nycommunities.org/sovereign-debt>; Amd § 489, Judy L.
- 65 Amd § 489, Judy L.
- 66 In a recent blog, Indermit Gill and Lee Buchheit propose incorporating certain features of typical insolvency regimes into laws to protect sovereign debtors (such as standstills, collective action, etc.). While the features they point to are uncontroversial as elements of a broader, comprehensive insolvency regime, once pulled from that regime and applied to creditors without the procedural and other safeguards that are part of a fully functioning insolvency regime, including importantly having an impartial judge oversee and administer the proceeding, one has to question whether the results for creditors will reflect the impartial and equitable process that most insolvency regimes seek to achieve.
- 67 For example, the "safe harbor" introduced to New York Judiciary Law § 489 in 2004 made the statute—even if it otherwise would have been applicable—essentially irrelevant to the holdout litigation resulting from Argentina's restructuring beginning in the 2000s.
- 68 Cf. G. Marcus Cole and Rodd J. Zywicki, *The New Forum Shopping Problem in Bankruptcy* (George Mason University School of Law, Stanford University Law School, Amsterdam Center for Law and Economics, 2009), available at <https://law.stanford.edu/wp-content/uploads/sites/default/files/publication/258941/doc/slspublic/Cole%20Forum%20Shopping.pdf>; Michael A. Francus, "Texas Two-Stepping Out of a Bankruptcy," *Michigan*

*Law Revue* 120 (2022): 38–50, [https://michiganlawreview.org/wp-content/uploads/sites/3/2022/08/120MichLRevOnline38\\_Francus.pdf](https://michiganlawreview.org/wp-content/uploads/sites/3/2022/08/120MichLRevOnline38_Francus.pdf) (discussing the migration of bankruptcy cases to jurisdictions where forum shopping is more common).

- 69 For example, a French law restricts a creditor’s ability to seize the assets of a sovereign if the creditor purchased a debt instrument in default or subject to a pending restructuring proposal if, among other requirements, the OECD recognized the sovereign as a recipient of official development assistance when the debt instrument was acquired. See Loi n° 2016–1691 du 9 décembre 2016 relative à la transparence, à la lutte contre la corruption et à la modernisation de la vie économique [Law 2016–1691 of December 9, 2016 on Transparency, the Fight against Corruption and the Modernization of Economic Life], *Journal officiel de la République française* [Official Gazette of France], December 9, 2016, Article 60. Indermit Gill and Lee C. Buchheit, “Targeted Legislative Tweaks Can Contain the Harm of Debt Crises,” *Brookings*, June 27, 2022, <https://www.brookings.edu/blog/future-development/2022/06/27/targeted-legislative-tweaks-can-help-contain-the-harm-of-debt-crises/>.
- 70 “Municipal Bankruptcy—Preemption—Puerto Rico Passes New Municipal Reorganization Act,” *Harvard Law Review* 128, no. 4 (2015): 1320–27.
- 71 Melissa Boudreau, “Restructuring Sovereign Debt under Local Law: Are Retrofit Collective Action Clauses Expropriatory?” *Harvard Business Law Review*, May 8, 2012.
- 72 11 U.S.C. ch. 9.
- 73 “Garuda Indonesia Files for Chapter 15 U.S. Bankruptcy Procedure,” *Reuters*, September 26, 2022, <https://www.reuters.com/business/aerospace-defense/garuda-indonesia-files-chapter-15-us-bankruptcy-procedure-ceo-2022-09-26/>; Ismi Damayanti and Nana Shibata, “Garuda Indonesia Creditors Approve Airline’s Restructuring Proposal,” *Nikkei Asia*, June 17, 2022, <https://asia.nikkei.com/Business/Transportation/Garuda-Indonesia-creditors-approve-airline-s-restructuring-proposal>.
- 74 United Nations Commission on International Trade Law, *UNCITRAL Model Law on Cross-Border Insolvency* (1997), [https://uncitral.un.org/en/texts/insolvency/modellaw/cross-border\\_insolvency](https://uncitral.un.org/en/texts/insolvency/modellaw/cross-border_insolvency); 11 U.S.C. §§ 1501–32; Mark Walker and Richard Cooper, “Venezuela’s Restructuring: A Realistic Framework,” *Cleary Gottlieb Steen & Hamilton*, September 19, 2017, <https://www.clearygottlieb.com/-/media/organize-archive/cgsh/files/2017/publications/venezuelas-restructuring--a-realistic-framework-9192017.pdf>; Mark Walker, *Thoughts on the Possible Restructuring of Venezuelan Debt* (LEC Abogados, 2020), <https://www.legalvenezuela.com/wp-content/uploads/2020/03/EntrevistaLECAbogadosMarkWalker.pdf>.
- 75 Some have suggested that the Companies Act should be modified so that a scheme (or a super scheme) could be used to restructure sovereign debt and an English court’s jurisdiction would extend to such sovereigns. Although we have seen no evidence that such a change is being considered, we believe it could be an interesting approach as it would in effect import a collective action mechanism into debt arrangements that do not now have them.
- 76 There are three parts to a scheme: the debtors’ proposal, the creditors’ supermajority consent approving the proposed amendment to the terms of debt, and the court’s sanction of the agreement. Although schemes don’t include an automatic stay like a US Chapter 11 proceeding, the subject company can apply for a provisional temporary injunction in certain cases. See, for example, *Companies’ Creditors Arrangement Act*, c. C-36 (U.K.), reprinted in R.S.C. 1985, s. 1. (Can.), available at <https://laws-lois.justice.gc.ca/eng/acts/c-36/>; Law No. 25.589, May 15, 2002 (Arg.), available at <http://servicios.infoleg.gob.ar/infolegInternet/anexos/70000-74999/74331/norma.html>; see also Walker and Cooper, *Venezuela’s Restructuring*.
- 77 See Part 26A of the Companies Act 2006. While a Part 26A scheme also requires the consent of 75 percent by value of shareholders or creditors, unlike a traditional scheme of arrangement, it does not require the consent of a majority by number of those voting, and the failure of one class of creditors to vote in favor of the scheme is not fatal.
- 78 One should not underestimate the obstacles to this approach. To name just two difficult issues: Which developing economy or economies would create the credit? What would be the process for aligning the value of the credit with the relief granted to the sovereign

debtor? ESG rating service providers could address some of these issues and develop metrics and methodologies to evaluate and rate these objectives as they have with climate change initiatives.

- 79 In terms of considering ways to induce greater private sector participation in sovereign lending and/or restructurings, maybe the simplest, though least likely, mechanism would be to offer investors providing new money or debt relief in specified circumstances an economic benefit that is funded in effect by the US Treasury (and/or other similar taxing authorities in the developed world)—that is, by providing a tax exemption or credit on interest income in the case of new lending to poor countries or a tax exemption or credit on eligible debt that is written off in an “approved restructuring.” Similar tax incentives have been a core driver of the US municipal bond market for decades and many other public policy initiatives that advance what is perceived to be public policies of national interest. Although clearly the public policy rationale for a tax subsidy in the municipal context may be more obvious and an easier sell politically, still one could construct a policy rationale in the case of aid to poor countries if the subsidy were viewed as advancing US national interests, reducing the US government’s spending on such matters through its contributions to the IMF and World Bank, and substituting private sector dollars for US government dollars more generally.
- 80 In the restructuring context, the provision of a benefit of this sort would likely attract criticism for shifting private sector losses to taxpayers generally or constituting a disguised taxpayer subsidy to a debtor government.
- 81 Anna Gelpern, “The IMF Revisits Sovereign Debt Restructuring, Not the SDRM,” Peterson Institute for International Economics, May 24, 2013, <https://www.piie.com/blogs/realtime-economic-issues-watch/imf-revisits-sovereign-debt-restructuring-not-sdrm>.
- 82 The UN Security Council provided that “petroleum, petroleum products and natural gas originating in Iraq shall be immune . . . from legal proceedings against them” except in the case of an ecological accident. The resolution was binding on UN members, and required them to incorporate the immunities and restrictions into their domestic laws. Iraq restructured “most of [its] debt stock on terms that gave [it] debt relief of at least 80 percent” as a result of the resolution’s protections. UN Security Council, Resolution 1483 (2003), adopted by the Security Council at its 4761st meeting, on May 22, 2003.
- 83 International Monetary Fund, *The International Architecture for Resolving Sovereign Debt Involving Private-Sector Creditors*, 45–46.
- 84 There are likely exceptions for some state-controlled enterprises in certain jurisdictions
- 85 Consider, for example, Argentina’s and Venezuela’s numerous successes in domestic courts over the years. In many instances, only the most aggressive vulture funds have proven able to come out successful over the sovereign in such contexts. Richard J. Cooper, Adam J. Brenneman, Carina S. Wallace, and Natalia Rezai, “Six Key Considerations for Argentine Creditors,” *Emerging Markets Restructuring Journal*, no. 10 (2019–2020), [https://www.cleargottlieb.com/-/media/files/emrj-materials/issue-10-winter-2019\\_2020/six-key-considerations-for-argentine-creditors-r1-pdf.pdf](https://www.cleargottlieb.com/-/media/files/emrj-materials/issue-10-winter-2019_2020/six-key-considerations-for-argentine-creditors-r1-pdf.pdf); Lee C. Buchheit, Anna Gelpern, Mitu Gulati, Ugo Panizza, Beatrice Weder di Mauro, and Jeromin Zettelmeyer, “Argentina and the Rebirth of the Handout Problem,” ch. 3 in *Revisiting Sovereign Bankruptcy* (Washington, DC: Brookings, 2013), [https://www.brookings.edu/wp-content/uploads/2016/06/CIEPR\\_2013\\_RevisitingSovereignBankruptcyReport.pdf](https://www.brookings.edu/wp-content/uploads/2016/06/CIEPR_2013_RevisitingSovereignBankruptcyReport.pdf); Tim Samples, “Rogue Trends in Sovereign Debt: Argentina, Vulture Funds, and Pari Passu under New York Law,” *Northwestern Journal of International Law and Business* 35, no. 1 (2014); Stratos D. Kamenis, *Vulture Funds and the Sovereign Debt Market: Lessons from Argentina and Greece*, Crisis Observatory Research Paper 13 (2014).
- 86 For simplicity’s sake, in the balance of this paper we use the term “official creditors” to refer to multilateral and bilateral creditors collectively, except where the context otherwise requires.
- 87 As between private creditors, the issues that most frequently arise are (1) the familiar ones of free riding and the outsized returns of noncooperating creditors, which can be disproportionately higher than cooperating creditors; (2) whether differences between credit terms justify different treatment even between creditors that in a nonsovereign context would be considered members of the same class and treated equally, for example, unsecured senior

creditors of the same debtor; and (3) whether different credit arrangements—secured, project based, quasi-secured, hybrid instruments, etc.—merit special treatment. There does not seem to be a groundswell to substitute ex ante solutions for intercreditor negotiation among private creditors. Moreover, the expanding diversity of credit schemes and entrants into the sovereign credit market suggests this problem will continue, at least at the margins of sovereign restructurings. These issues will require a case-by-case approach, at least until market practice converges on a set of acceptable solutions. Accordingly, we do not give further consideration to intercreditor equity in this paper.

- 88 Livia Hinz, “Private Sector Involvement in Sovereign Debt Governance in the Post-Pandemic World: The Role of the ‘Comparability of Treatment’ Principle,” *European Journal of Legal Studies* 14, no. 1 (2022): 25–43. The Common Framework is, officially, the “Common Framework for Debt Treatments beyond the DSSI (Debt Service Suspension Initiative).” We recognize that the Common Framework as defined today is available only for the 73 poorest countries that request treatment under its auspices. Nonetheless there is no inherent reason why its principles should be so limited.
- 89 Zambia, which defaulted on its Eurobonds in November 2020, requested treatment under the Common Framework on February 1, 2021. An agreement as to the terms of the restructuring of its official debt was not reached until late June of 2023. The agreement provides for a dramatic reduction in interest rates, a 3-year grace period for the repayment of principal and a long maturity extension. The only somewhat innovative element is a provision requiring an increase in the interest rate and a shortening of the final maturity in the event that Zambia’s debt repayment capacity improves from weak to medium.
- 90 See Sovereign Debt Working Group, *Debt Transparency*.
- 91 *How to Make Sovereign Debt Restructurings More Effective* (Lazard, May 2022), [https://www.lazard.com/media/452075/20220506-lazard-policy-brief-on-comparability-of-treatment\\_vf.pdf](https://www.lazard.com/media/452075/20220506-lazard-policy-brief-on-comparability-of-treatment_vf.pdf); Diego Rivetti, *Achieving Comparability of Treatment under the G20’s Common Framework*, Equitable Growth, Finance, and Institutions Notes (Washington, DC: World Bank, 2022), <https://documents1.worldbank.org/curated/en/426641645456786855/pdf/Achieving-Comparability-of-Treatment-under-the-G20-s-Common-Framework.pdf>.
- 92 G20, “Statement: Extraordinary G20 Finance Ministers and Central Bank Governors’ Meeting,” Saudi Arabia 2020 Riyadh Summit, November 13, 2020.
- 93 G20, “Statement.”
- 94 Although the IMF technically does not restructure its outstanding credits, it has, most recently in the case of Argentina, rolled over credits into a new IMF-supported program.
- 95 The IMF’s ultimate decision to proceed is conditioned on its determination that, together with the resources provided by it, commitments from others (official and private) are in the aggregate adequate to finance the sovereign debtor’s IMF-approved economic program.
- 96 See Sovereign Debt Working Group, *Debt Transparency*.
- 97 Refer to Greece, where in the run-up to determining the contours of Greece’s final program, the IMF updated its DSA on at least one occasion and each time increased the haircut imposed on private creditors without changing the contribution of official creditors. Such behavior not only was considered high-handed by private creditors but also reinforced the country’s concern that the IMF was biased against it. Refer also to the discussion of procedural transparency in the Bretton Woods Committee’s paper on transparency: Sovereign Debt Working Group, *Debt Transparency*.
- 98 Interestingly, the HIPC Initiative envisages the calculation of a so-called common reduction factor, which is a net present value reduction applicable to all participating creditors *assuming that all creditors expected to participate do so*. This approach would seem to protect participating creditors from shouldering the burden abandoned by free riders, but it is not clear how the resulting shortfall in resources would be covered.
- 99 A third precedent is to be found in the latest iteration of CACs incorporated in sovereign bonds. The International Capital Market Association’s model CAC (designed for sovereign bondholders) adopts a rigid rule in the case of a proposed modification of the terms of bonds of multiple series based on a single combined supermajority vote across the affected series bonds (a so-called single-limb cross-series modification). In this case, all bondholders must be offered the identical instrument (or an identical choice among

- instruments). This is the case regardless of differences in tenor, interest rate, amortization, or other term of the bonds to be modified. Whether one agrees with this approach or not, it is evident that where different creditors have very different types of credit instruments it is neither a workable solution nor a valuable guidepost. Indeed, the top-down rather than case-by-case approach of the DSSI is in the opinion of many one of the principal reasons why it attracted virtually no private sector support.
- 100 Although it has cut new lending severely for internal reasons, it remains the predominant creditor.
- 101 It has been claimed that the Zambian restructuring was delayed significantly at the outset due in part to a lack of experience and coordination amongst Chinese lenders, but also more intentional delaying tactics such as posing numerous questions at the creditor meeting and insisting that the World Bank and IMF take losses in the Zambian debt restructuring. <https://www.ft.com/content/6c318284-cae0-4293-bbef-ac6805b19c06>; <https://www.scmp.com/news/china/diplomacy/article/3208860/china-calls-multilateral-lenders-ease-zambias-debt-burden>; Anna Gelpern, Sebastian Horn, Scott Morris, Brad Parks, and Christoph Trebesch, *How China Lends: A Rare Look into 100 Debt Contracts with Foreign Governments*, CGD Working Paper 573 (Washington, DC: Center for Global Development, 2021), <https://www.cgdev.org/publication/how-china-lends-rare-look-into-100-debt-contracts-foreign-governments>; Harry Clynh, “Should China Be Blamed for Zambia’s Debt Talks Holdup?,” *African Business*, January 31, 2023, <https://african.business/2023/01/trade-investment/should-china-be-blamed-for-zambias-debt-talks-holdup/>; Christopher Condon and Matthew Hill, “China Delays Zambia Debt Deal over Local Loans: US Official,” Bloomberg, January 24, 2023.
- 102 In a seeming contradiction to this claim, we understand that the China Development Bank believes it should be accorded preferential creditor status. And interestingly most Chinese loans are backed by credit insurance issued by Sinosure, a state-owned credit insurance agency.
- 103 For example, if a debtor country agrees to an interest rate on a loan of 5 percent per annum and at the same time agrees to sell commodities to the lender at prices reflecting a discount from the market price, the effective interest rate is more than 5 percent.
- 104 There are, of course, ways for MDBs to protect their credit rating and at the same time accept greater credit risk. Among other things, their country shareholders can provide credit support or contingent capital if need be.
- 105 In the case of the Greek restructuring in 2012–13, the IMF rejected a request by Greece that government bonds held by individuals be exempt from restructuring. On the other hand, bonds purchased by the European Central Bank in the secondary market were effectively exempted.
- 106 The choice of a single discount rate or multiple rates (reflecting the yields of respective private and official debt) used to determine net present value, for example, has a significant impact on the level of debt reduction in nominal terms required of private and official lenders to achieve parity. The argument for different rates (which may be cumbersome and not without controversy) is based on notions of fairness; the argument for a single rate is based on simplicity and ease of implementation. Both have merit. World Bank, *World Development Report 2022: Managing Sovereign Debt* (Washington, DC: World Bank 2022); Julie Kozack, *Considerations in the Choice of the Appropriate Discount Rate for Evaluating Sovereign Debt Restructurings*, IMF Policy Discussion Paper PDP/05/9 (Washington, DC: International Monetary Fund, 2005), <https://www.imf.org/external/pubs/ft/pdp/2005/pdp09.pdf>.
- 107 Moreover, the G20’s statement on the Common Framework specifies that the contribution of private creditors shall be “at least as favorable as that provided by official bilateral creditors [emphasis added],” thus suggesting (threatening?) that they may be asked to do more.
- 108 Indeed, in the Ukraine case special treatment had to be granted to holders of the shortest maturities to secure their support of the program.
- 109 See, for example, the contentious negotiation of the Glencore prepayment for oil in Chad.
- 110 See endnote 34 for additional background on rollups.

111 Some participants argue in favor of a single discount rate of 5 percent, which the IMF uses in its DSA calculations. Others argue that using different discount rates to reflect values makes more sense. The former will produce larger discounts from face value for commercial debt as compared to official debt.

112 Among the technical issues to be addressed are these:

- How is the provision of new money to be compared to reprofiling or a principal haircut? In comparing a front-loaded amortization schedule (that could be said to create a priority of repayment) with credits of longer duration is net present value the only consideration? The IMF seems to consider that being paid out first has a value of its own.
- Might comparability of treatment mean that secured debt ought to be stretched out in some cases? Is there a formula that can tell us when and by how much?
- Should certain undisclosed debt contract provisions that might confer priority but are viewed as antithetical to good practice be disregarded?

In all likelihood, these issues can only effectively be addressed in the context of the actual restructurings in which they arise.



## Bretton Woods Committee

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