CLEARY GOTTLIEB

Moving Towards More Equitable Burden Sharing in Sovereign Debt Restructuring

Burden sharing isn't working. The latest initiatives by the official sector – the Debt Service Suspension Initiative (DSSI) and the Common Framework – have fallen short of expectations, and the diverse interests of creditor groups appear as misaligned as ever.

Private-sector participation in the DSSI has not materialized, while the Common Framework has shown itself to be a slow and ineffective tool for resolving sovereign debt crises. Since its introduction more than two years ago, just four countries have requested relief under the program and, to date, none of them have concluded a restructuring.

While the recently formed Global Sovereign Debt Roundtable organized by the IMF, the World Bank, and the Indian G20 Presidency is working towards a consensus among the private and public sectors on how to improve the management of sovereign debt crises, it is too early to say whether real progress will be made. At the same time, Chinese lending to developing countries has fallen sharply, and China has been a reluctant participant in coordinated debt restructuring.

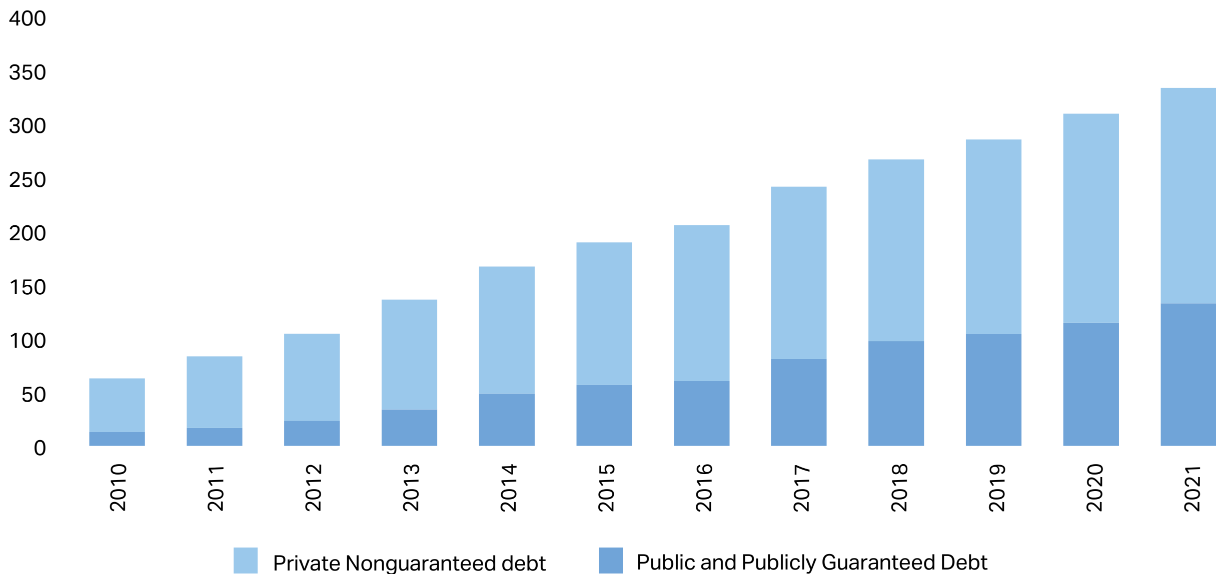
21%

PRIVATE CREDITORS ACCOUNTED FOR 21% OF EXTERNAL GOVERNMENT AND GOVERNMENT GUARANTEED DEBT ISSUED BY THE POOREST COUNTRIES AS OF THE END OF 2021

There is a broad agreement that the current architecture needs reform, but less accord on how to move forward. However, with private creditors accounting for 21% of external government and government guaranteed debt at the end of 2021 (rising to 61% for lower middle-income nations) and China 49%, any meaningful progress will require movement from all parties[1].

[1] https://thedocs.worldbank.org/en/doc/6e72b0ded996306fa01f5db7a0c38b19-0050052021/related/IDR2022-Foreword-by-President-Malpass.pdf

International Development Association-Eligible Countries' Long-Term External Debt Owed to Private Creditors, 2010–2021 US ($Bn)



Source: World Bank

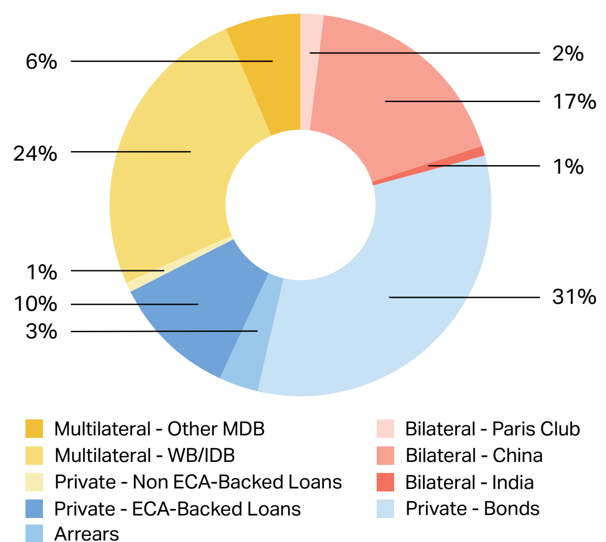
The Challenge of China

The Common Framework was intended to align the actions of all bilateral creditors. However, Chinese bilateral creditors have tended to resist coordinating with others in favor of largely private case-by-case bilateral arrangements to the detriment of private creditors. Efforts to build a consensus have been further complicated by China's insistence that only the China Export-Import Bank is an official creditor and its largest lender, China Development Bank, is a commercial creditor.

Moreover, while debt stock reductions are usually a staple element of developing national debt restructurings, China has instead preferred to seek new lending or re-profiling, with the aim of both maintaining the nominal value of its claims and achieving a greater recovery value than other official creditors.

A typical case is that of Suriname, which has been unable to access $700mn worth of IMF loans because the Export and Import Bank of China initially refused to negotiate a restructuring of the debts Suriname has with the bank. The South American nation of 600,000 people is one of many middle- and lower-income countries grappling with a growing debt crisis. Yet, support has been held up by the wider geopolitical confrontation between the U.S., and what are viewed as Western institutions like the IMF, and a rising China which will only negotiate with the Surinamese government.

Suriname: External Public Debt, End-2020 (% of GDP) (Percent of GDP)

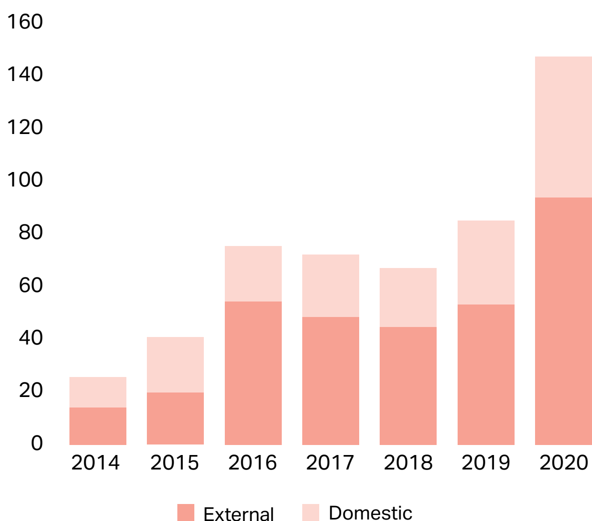


Source: International Monetary Fund

China's stance on restructuring finds some support in the fact that its loans are made to support specific projects and investments, rather than general government purposes. This distinction supports its view that most of its lending should be considered commercial.

While the Paris Club of creditor nations, India, and private creditors, such as Franklin Templeton and Eaton Vance, have agreed to restructure their credits to Suriname, negotiations between the country and China are ongoing, leaving the South American nation in a challenging economic position.

Suriname: Public Debt (% of GDP)



Source: International Monetary Fund

Progress Not Perfection

How exactly can these hurdles to a more equitable approach to burden sharing be overcome? Could a solution involve the inclusion of the private sector on a more equal footing with official creditors, or greater participation from China?

A MATHEMATICAL SOLUTION TO BURDEN SHARING THAT WILL SATISFY ALL STAKEHOLDERS, SUCH AS EQUALIZING NET PRESENT VALUE, IS UNLIKELY

A mathematical solution to burden sharing that will satisfy all stakeholders, such as equalizing net present value, is unlikely, but there could be agreement on the process or, at the least, an opportunity to contribute to the design of the liability management exercise. For that to happen, all creditors will need to have access to adequate information regarding claims against the debtor, including relevant provisions of non-debt documents that essentially modify the terms of the debt documents.

The variety of different types of debt, including unsecured and secured bank loans, bonds, loans to state-owned enterprises (SOEs) with positive cash flow, myriad hybrid instruments, project finance, domestic currency loans and bonds, and more, raise the question of whether all should be treated equally or whether some should be excluded. For example, often short-term debt, including trade finance, domestic currency debt, derivative exposure, project finance and lending to SOEs that are current on their payments and able to service their debts have been excluded or given special treatment.

'Specific Concerns'

CARVING OUT SPECIAL TREATMENT FOR SOME OFFICIAL CREDITORS IS A CLEAR INVITATION FOR PRIVATE CREDITORS TO SEEK SIMILAR TREATMENT, CITING THEIR OWN 'SPECIFIC CONCERNS'

It may seem unwise to grant different treatment to the same debt based on the nationality or nature of the creditor, but this is often the case. In fact, the Common Framework explicitly recognizes that different official creditors may be entitled to special treatment based on their "specific concerns", such as multilateral development banks' (MBDs) desire to protect their credit rating to maintain low borrowing costs. This could be seen as an intra-creditor issue for official creditors. However, it becomes one of equitable burden sharing if it results in official creditors being offered a free pass or favorable treatment at the expense of the private sector.

Carving out special treatment for some official creditors is a clear invitation for private creditors to seek similar treatment, citing their own "specific concerns". If the goal is to attract more private sector capital to developing markets, there is a strong argument for asking MBDs to find a way to provide some kind of financial relief, and not just advice. One of China's long-standing demands has been that MDBs share some of the burden of restructurings, so such a move could have multiple payoffs.

Other considerations could include measures to incentivize the provision of extra lending from the private sector in exchange for preferential treatment, as is often the case for MDBs. Could the increased use of blended capital techniques help to dispel some of the issues around equitable burden sharing?

The answers to these questions will not be the same in all cases, but they should be posed in an effort to create a fairer restructuring architecture that ultimately attracts the funding that middle- and lower-income countries need.

THE BIGGEST HURDLE REMAINS CONVINCING CHINA TO COORDINATE WITH OTHER CREDITORS AND AGREE TO A UNIFIED APPROACH TO SOVEREIGN DEBT MANAGEMENT SITUATIONS

However, the biggest hurdle remains convincing China to coordinate with other creditors and agree to a unified approach to sovereign debt management situations. This may be as tied up in politics and diplomacy as it is in finance and law, but any progress that can be made on equitable burden sharing by reform of the Common Framework can only make the prospect more attractive.

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