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A sovereign debt restructuring mechanism for developing countries



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Introduction

Various commentators, including Elliot Harris and Chris Lane (2023) of the United Nations (UN), have observed that sovereign indebtedness has the potential to prevent governments from achieving the Sustainable Development Goals (SDGs). The observations have contributed to numerous proposals for ameliorating constraints imposed by high levels of indebtedness through decreasing debt service payments. In line with past mechanisms, the proposals advocate for combinations of reduced principal amounts, lower interest rates, and longer debt maturities.³ Proposals also recognize the roles of international financial institutions (IFIs), such as the International Monetary Fund (IMF) and multilateral development banks (MDBs). In other words, the proposals contain elements of the Brady Plan, the Heavily Indebted Poor Countries (HIPC) Initiative, and the Multilateral Debt Relief Initiative (MDRI).

Due to its dependence on markets, the Brady Plan was special. Brady Bonds, relying primarily on collateralization and standardization, made the trading of emerging market (EM) debt possible. The fundamental shift from illiquid loans to tradeable securities promoted price discovery and risk sharing. Still, the Brady Plan—introduced in 1989—remained concentrated on EM sovereign debt denominated and settled in United States Dollars (USD). In fact, the Brady Plan required collateral in the form of United States Treasury marketable securities (US Treasuries). In order to purchase the US Treasuries to be posted as collateral, EM sovereigns had to obtain USD loans from IFIs.

Ying Qian (2021) has suggested that solutions similar to the Brady Plan may be appropriate for distressed debt restructuring in the post-COVID era. The mechanism outlined in this article builds on the Capital Market Development approach of the Brady Plan by proposing an intermediary solution between 1) EM sovereign debt denominated and settled in USD

and 2) EM sovereign debt denominated and settled in local currency (LCY). Specifically, using non-deliverable cross-currency swaps, USD-denominated and USD-settled sovereign debt is de facto converted into LCY-denominated and USD-settled sovereign debt. Importantly, distressed sovereigns do not have to post collateral, IFIs do not have to approve new loans to the distressed sovereigns, and current sovereign lenders continue receiving USD payments on USD principal amounts.

Since the successful implementation of the mechanism is predicated on the judicious management of multi-party relationships, the UN is expected to have a steering function. The UN is ideally positioned to collaborate productively with sovereigns and IFIs. In particular, it can provide unbiased advisory services to sovereigns, ensuring equal treatment, knowledge transfer, and operational transparency.

An innovative sovereign debt restructuring mechanism

Debt is issued either at home or abroad. In this article, debt issued at home is defined as domestic, and debt issued abroad is defined as external. Therefore, the legal jurisdiction governing the issuance is determinative.

A contract has a currency of denomination and a currency of settlement. Denomination refers to the currency of the nominal value or the notional amount.⁴ Settlement refers to the currency in which payments due are made. For example, US Treasuries are USD-denominated and USD-settled, meaning that US Treasuries have USD nominal values and that US Treasuries generate cashflows—interest payments and principal repayments—in USD. However, a bond may be denominated in one currency and settled in another currency. For instance, a bond may be LCY-denominated and USD-settled, meaning that the payments due—interest and principal—are in LCY but are made—at USD/LCY spot—in USD.⁵ The distressed debt of de-

veloping countries of interest in this article is external debt. Without loss of generality, this external debt is assumed to be USD-denominated and USD-settled.

As our purpose here is to recommend a sovereign debt restructuring mechanism, we do not delve into each combination of reduced principal amount, lower interest rate, and longer debt maturity. To illustrate the mechanism, only the case of a lower interest rate and a longer debt maturity is presented. Also, the net financial impact of the lower interest rate, the longer maturity, and the higher credit quality on the current sovereign lenders is not examined.⁶

Let us consider the following hypothetical situation. An EM sovereign is experiencing financial distress. The sovereign, which has borrowed USD 100 million from a syndicate of financial institutions at 10% per annum, cannot deliver on its obligations. The remaining term of the borrowing is 5 years. Under the auspices of the UN, the World Bank (WB) and The Currency Exchange Fund (TCX) may suggest the following arrangement:⁷

1. The remaining term of the borrowing is extended from 5 years to 10 years.
2. Because the LCY/USD spot rate is 15 and because the 10-year LCY interest rate is 20%, the sovereign and the WB enter into the following non-deliverable cross-currency swap contract:
 - a. The sovereign pays the WB 18% on LCY 1,500 million, and all payments are made in USD at the USD/LCY spot rate;⁸
 - b. The sovereign receives from the WB 5% on USD 100 million;
 - c. WB payments to the sovereign are not conditional on sovereign payments to the WB;⁹ and
 - d. There is no initial exchange of notional amounts.
3. The WB and TCX enter into a swap that mirrors the sovereign-WB swap.¹⁰

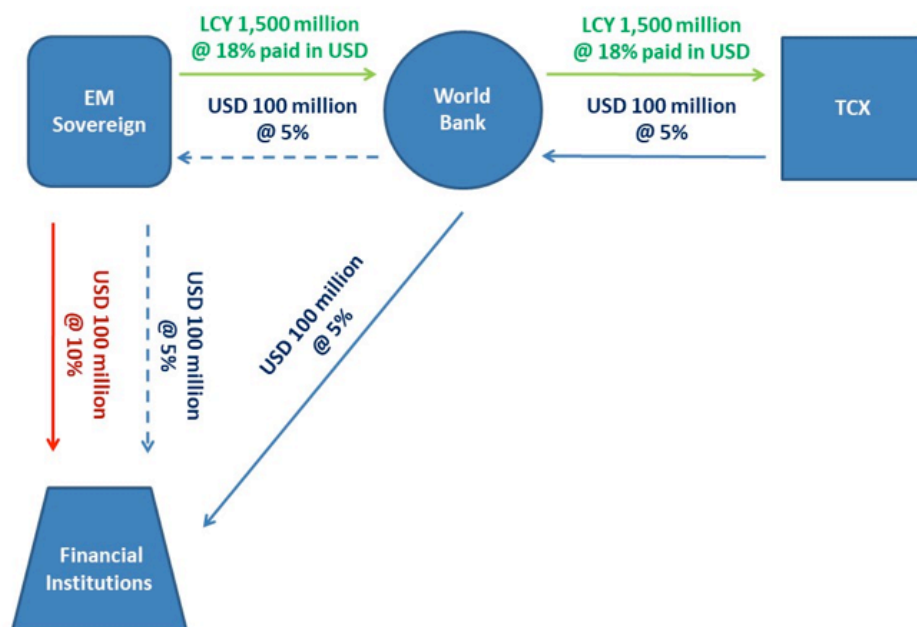


Figure 1. LCY-USD Sovereign Debt Restructuring Mechanism

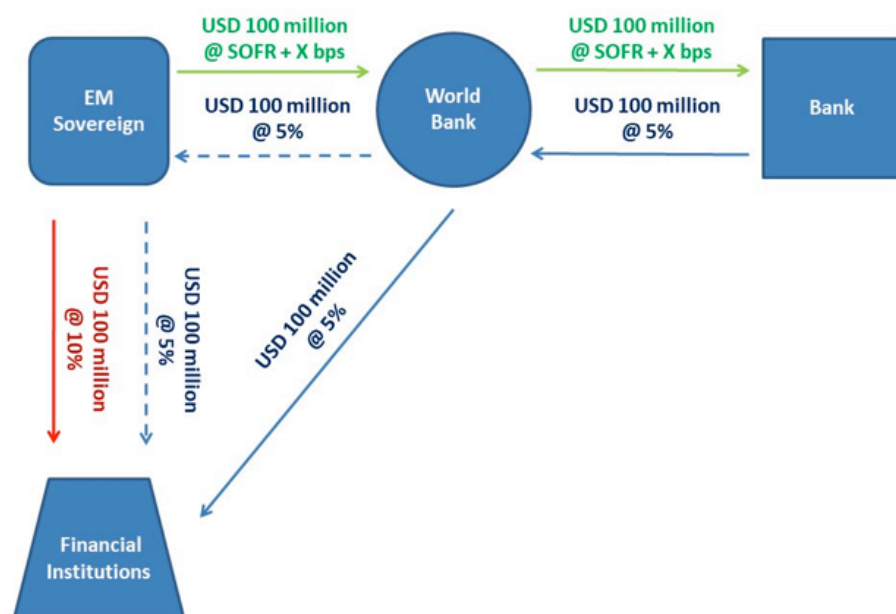


Figure 2. USD Sovereign Debt Restructuring Mechanism

4. WB payments to the sovereign are routed to the syndicate of financial institutions through an escrow account.¹¹

The sovereign pays a higher interest rate in LCY than in USD, but the LCY rate is lower than the LCY rate at which the sovereign borrows domestically. While payments have to be made in USD, the resolution of distress is a vital first step, and the sovereign is supposed to be engaged with the IMF. The sovereign does not

borrow new funds from IFIs in order to post collateral.

On the one hand, the financial institutions accept a longer contract duration and a lower interest rate. On the other hand, they are no longer exposed to the credit risk of the sovereign, as all payments are made by the WB (through an escrow account).¹²

The WB is exposed to the credit risks of the sovereign and TCX.¹³ While the absence of netting in the sovereign-WB swap is unusual, the arrangement is likely

superior to a sovereign loan. TCX, being long LCY and short USD, operates within its core mandate. A stronger capitalization and a transaction with an AAA-rated counterparty are positive for TCX.

A USD Alternative

The recommended sovereign restructuring mechanism takes the view that, during a period of distress, the sovereign is likely to prefer LCY exposure to USD exposure. Naturally, the sovereign may prefer USD exposure to LCY exposure. In the event that the sovereign wishes to switch from fixed-rate USD exposure to floating-rate USD exposure, the following arrangement may be suggested:

1. The remaining term of the borrowing is extended from 5 years to 10 years.
2. Because the exposure is in USD, the sovereign and the WB enter into the following non-deliverable cross-currency swap contract:
 - a. The sovereign pays the WB the Secured Overnight Financing Rate (SOFR) + X basis points (bps) on USD 100 million, where the X bps compensate the WB for the sovereign's counterparty risk;¹⁴
 - b. The sovereign receives from the WB 5% on USD 100 million;
 - c. WB payments to the sovereign are not conditional on sovereign payments to the WB;¹⁵ and
 - d. There is no initial exchange of notional amounts.
3. The WB and TCX enter into a swap that mirrors the sovereign-WB swap.
4. WB payments to the sovereign are routed to the syndicate of financial institutions through an escrow account.

Conclusion

The proposal outlines a sovereign debt restructuring mechanism for developing countries which, while simplifying the arrangements among the active participants, also aims to allocate risks optimally. Concretely, as well as significantly, sovereigns do not have to post collateral, sovereign exposures are transformed from USD to LCY, IFIs do not have to issue new loans to the distressed sovereigns, and current sovereign lenders continue receiving USD payments on USD nominal values. This mechanism should be considered among the proposals being advanced to decrease EM debt service payments.

References

1. Qian, Y. (2021) "Brady Bonds and the Potential for Debt Restructuring in the Post-Pandemic Era". Boston University Global Development Policy Centre accessed online.

2. Harris, E and Lane, C. (2023) "Debt as an Obstacle to the Sustainable Development Goals." United Nations Blog accessed online.

Footnotes

1. The views expressed herein are those of the author and do not necessarily reflect the views of his employer.

2. Writing in his personal capacity.

3. Face value, par value, and principal amount (often, simply principal) are different references to nominal value.

4. Other terms for notional amount are notional principal and notional value. In the case of derivative contracts, such as swaps, the terms are meant to indicate that they are used to calculate payments due on the contracts.

5. Such a bond may be called a synthetic LCY-denominated bond.

6. For instance, when credit risk is reduced, as when a lowly rated counterparty is replaced by a highly rated counterparty, a lower interest rate may not result in a financial loss.

7. The WB is defined as the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA). The WB is an MDB. TCX was created to promote LCY lending: <https://www.tcxfund.com/>. One of the authors was the inaugural Deputy Managing Director, as well as a Statutory Director, of TCX Investment Management Company, and TCX granted the author a fully delegated responsibility for the transaction process of TCX.

8. If the sovereign does not have a domestic yield curve that allows TCX to transact a 10-year fixed-rate LCY leg, a floating-rate LCY leg may have to be explored.

9. That is, there is no netting.

10. Given the sizes of EM sovereign debt exposures, the capitalization of TCX may have to be strengthened to en-

sure that risk limits are respected.

11. For the sake of simplicity, without loss of generality, the financial institutions are assumed to be buy-and-hold investors.

12. Both IBRD and IDA are AAA-rated institutions.

13. TCX is rated A1/stable by Moody's and A/stable by S&P.

14. If the sovereign does not have a domestic yield curve that allows TCX to transact a 10-year fixed-rate LCY leg, a floating-rate LCY leg may have to be explored.

15. That is, there is no netting.