A Modern Template for the Restructuring of Poor Country Debts

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Summary

Sixty per cent of low-income countries are in "debt distress" or at high risk of it. The current sovereign debt restructuring framework leads to unsustainable debts over the long term, a continuing repeat of the crisis/debt restructuring cycle, economic stagnation and poverty in low-income countries. This paper proposes that the International Financial Institutions (IFI) provide the funding needed for over-indebted low-income countries to achieve a more durable resolution of their debt problems following the Brady Plan precedent.

Two proposed bond exchange structures provide a new template for sovereign debt restructuring. They simplify the Brady concept and increase the liquidity of the restructured instruments significantly. The entire stock of the government's external bonds will be converted into an equal nominal amount of 25-40 year debt with a 3-3.5% interest rate. The result should reduce the net present value of the debt by more than 50% and place the debt on a sustainable path.

Under the Cash Down-Payment Structure, investors receive a cash down-payment of the existing bond equal to 30-35% of the bond's current market value plus a new standard long-term bond with no write-down of the principal amount. Under the Floor of Support Structure, investors receive a new long-term bond of equal nominal amount that has a liquid rising floor of support with an initial value of 60-70% of the existing bond's current market value. The floor of support is based upon the investor's ability to convert the new bond into a World Bank zero-coupon bond at any time. The AAA minimum value will rise to 100% of the nominal amount of the original bond at the maturity of the new bond. Under both Structures, the market value received by the investor is significantly higher than the current market value of the existing bonds.

Based upon a US$ 10 billion external bond stock, total IFI financing is US$ 1 billion under the Cash Down-Payment Structure and US$ 2 billion under the Floor of Support Structure. The sharing of the financing requirement across a number of IFI will minimize the financial demands on lenders. IFI funds can be provided through a combination of new loans and repurposing of undrawn amounts under existing loans, again following the Brady precedent. The IFI loans should contain provisions that restrain excessive borrowing.

I. Introduction

The official sector has rung the tocsin as loudly as it can. Both the IMF and the World Bank have warned that fully 60% of low-income countries are in "debt distress" or at high risk of it. Bonds of more than a dozen developing nations now trade at a price below 50 cents on the dollar. The culprits? Unprecedentedly large sovereign debt stocks. Rising interest rates. Depreciating local currencies. Withdrawal of massive liquidity injections by major central banks. Vertiginous leaps in the cost of food, fuel and fertilizer. 2022 was a bad year for sovereign debt defaults; 2023 will probably be worse.

As the queue of patients in front of the debt restructuring intensive care ward lengthens, the prospects for a speedy and durable recovery are fading. The traditional machinery employed to resolve sovereign debt difficulties is proving to be inadequate to handle a more diverse set of bilateral and

commercial creditors. Moreover, each of the *dramatis personae* in this drama — the debtor, the creditors and the official sector institutions — will have its own reasons for accepting debt treatments that represent only a temporary palliative for the sovereign borrower. This explains the phenomenon of the "serial sovereign debt defaulter" so visible in this century.

The last time the world confronted anything like this was in the 1980's when more than two dozen countries were forced to restructure their external debts. That crisis ended in the early 1990s through the use of a template transaction structure, the Brady Plan, that stretched out the legacy debt stocks for 30 years with, at the election of each creditor, either a reduction in the nominal amount of the debt or a below-market fixed interest rate. The secret to the success of the Brady Plan lay in that 30-year stretch out with a bullet principal maturity. The commercial bank lenders of that era accepted this feature because the sovereign debtors pledged, as collateral security for the repayment of principal at maturity, U.S. Government debt securities that matured at the same time as their Brady bonds. The debtor countries borrowed the money to buy that collateral from the IMF and the World Bank.

It is not possible or desirable in 2023 simply to replicate the Brady Plan. With interest rates at current levels, the cost of the collateral would be prohibitively high. In addition, Brady bonds were designed by commercial bankers to appeal to commercial bankers. Bond investors never really took a shine to Brady bonds. The hybrid nature of the credit risk (U.S. Government risk as to principal in 30 years and sovereign issuer risk for interest payments during that period) made the instruments difficult to price and trade. As a result, most Brady bonds were retired within ten years of issuance.

The important lesson of the Brady experience, however, is that a contagious emerging market sovereign debt crisis can be arrested through the deployment of a template transaction structure that offers the legacy debt holders a measure of official sector-financed support in return for a long-term stretch out of maturity and a significant reduction in the interest rate of their credits.

II. A New Template for Sovereign Debt Restructuring

The goal of this proposal is to convert the entire stock of the government's external bonds into an equal nominal amount of 25-40 year debt (New Bonds) with a 3-3.5% interest rate. The result should reduce the net present value of the debt by more than 50% and place the debt on a sustainable path.

The IFI[1] would be asked to lend the government the funds specifically to meet the cash requirements of the proposal. This is not new territory. The World Bank and the IMF provided funds for the purpose of financing the cash collateral and the purchase of the US Treasury zero-coupon bonds used as collateral in the Brady debt restructurings in the 1990s. The World Bank and IMF loans were explicitly linked to the Brady restructurings.

The current proposal targets government external bonds in default or with a very high likelihood of restructuring as evidenced by market prices below 40% of nominal amount. Candidates currently include Ghana, Sri Lanka and Pakistan.

The two proposed structures simplify the original Brady concept and increase the liquidity of the restructured instruments significantly. Investors would be offered a choice between the two structures. A US$ 10 billion nominal amount stock of external bonds has been utilized for illustrative purposes.

[1] World Bank, IMF and the relevant regional development bank. Other official multilateral and bilateral lenders will be invited to participate in the initiative.

Under the Cash Down-Payment Structure exchange, investors will receive an immediate cash down-payment of their existing bonds equal to 30-35% of the bond's current market value plus a new standard long-term bond of the government with no write-down of the principal amount of the bond. The investor recovers a significant portion of the market value of its holding in cash immediately and has a new bond of a borrower with a now sustainable debt. The sum of the cash down-payment and the market value of the New Bond will be significantly higher than the current market value of the government's external bonds.

Under the Floor of Support Structure exchange, the investor will receive a new long-term bond of the government (again, with no write-down in principal amount) that includes a rising AAA-rated floor of support with an initial value of 60-70% of the current market value of the existing bonds. The AAA minimum value is based upon the investor's ability to exchange its New Bond into a long-term World Bank (or other AAA-rated issuer) zero-coupon bond at any time. The accreted value of the zero-coupon bond will rise over time to 100% of the nominal amount of the New Bonds at their maturity.

Under the Floor of Support Structure, the investor will have a secure minimum value for its holding that protects against one of the main risks of emerging market sovereign bonds (a catastrophic fall in the value of the instrument). The market value of the New Bond with its floor of support will be significantly higher than the current market value of the government's external bonds.

The Appendix details Summaries of the Terms and Conditions of the two Structures.

III. IFI Loans to Finance Cash Requirement of Exchange

The required IFI financing would be shared among the World Bank, the IMF, the relevant regional development bank and, perhaps, other official multilateral and bilateral lenders. The sharing of the financing requirement across a number of institutions will minimize the financial demands of the proposal on any one lender.

Under the Cash Down-Payment Structure, the IFI would provide total loans to the government of US$1 billion to finance the 10% cash down-payment of the Original Bonds based upon a US$ 10 billion external bond stock.

Under the Floor of Support Structure, the IFI would provide total loans to the government of US$ 2 billion equal to the 20% of nominal amount purchase price of the World Bank zero-coupon bond based upon a US$ 10 billion external bond stock. The government will use the IFI loan proceeds to purchase the World Bank zero-coupon bond just as governments used IMF/World Bank loan proceeds to purchase US Treasury zero-coupon bonds to collateralize the Brady Bonds in the 1990s.

The 20% of nominal amount purchase price of the World Bank zero-coupon bond will be the market price of a World Bank zero-coupon bond at the time of the operation. The World Bank can use derivatives to transform the US$ 10 billion nominal amount zero-coupon bond into a standard US$ 2 billion floating rate liability.

Under the Floor of Support Structure, the redemption proceeds of the World Bank zero-coupon bond will repay the New Bonds at maturity discharging in full the government's repayment obligation under the New Bonds.

Based upon a US$ 10 billion external bond stock and a sharing of the IFI financing requirement of 33.3% World Bank, 33.3% IMF; 20% regional development bank; 13.4% other official multilateral and bilateral lenders, the funding contributions of the IFI will be:

	Cash Down-Payment Structure	Floor of Support Structure
World Bank	US$ 333 million	US$ 667 million
IMF	US$ 333 million	US$ 667 million
Regional Development Bank	US$ 200 million	US$ 400 million
Other Official Lenders Combined	US$ 134 million	US$ 266 million

The funds will be provided through a combination of new loans and the repurposing of undrawn amounts under existing loans following the Brady Plan precedent. In the case of the Mexico Brady restructuring, the World Bank provided a total of US$ 2 billion through a new loan of $1.26 billion and the redirection of US$ 750 million of previously approved but undisbursed loans for the Public Enterprise, Industrial, Fertilizer, Agricultural and Steel sectors.

IV. Government Debt Burden

Under the proposal, the debt burden of the government is dramatically reduced and is comparable under the two structures. The net present value of the debt will fall by more than 50% and the debt will be placed a sustainable path.

A. Cash-Down-Payment Structure

The government post-exchange debt based upon the US$ 10 billion nominal amount of Original Bonds will be:

US$ 9 billion nominal amount New Bonds (90% of nominal amount of Original Bonds) with a 25-30 year maturity and a 3-3.5% interest rate

US$ 1 billion nominal amount IFI loans (10% of nominal amount of Original Bonds)

Net Debt: US$ 10 billion nominal amount (100% of the nominal amount of Original Bonds)

B. Floor of Support Structure

The government post-exchange debt based upon the US$ 10 billion nominal amount of Original Bonds will be:

US$ 10 billion nominal amount New Bonds (100% of nominal amount of Original Bonds) with a 35-40 year maturity and a 3-3.5% interest rate

US$ 2 billion nominal amount IFI loans (20% of nominal amount of Original Bonds)

In the Floor of Support Structure, the debtor government would continue to own the World Bank zero-coupon bonds that provide the floor of support for the corresponding New Bonds but those zero-coupon bonds would be irrevocably pledged to a third party trustee and could be used only in the manner contemplated by the Floor of Support Structure.

Because the New Bonds will have a nominal value equal to the outstanding principal amount of the existing bonds for which they will be exchanged and to the nominal value of the World Bank zero-coupon bonds, and because the World Bank zero-coupon bonds will have, on the date of their purchase, a market value equal to the IFI loans incurred to finance that purchase, there should be no increase in the net debt of the country (100% of the nominal amount of the Original Bonds).

There will be small differences in the cost of the two Structures due to differences between the interest rates on the IFI loans, the accrual rate on the World Bank zero-coupon bond and the interest rate on the New Bonds. The effect will be small because the interest rate differentials will be minimal and will only apply to 10-20% of the post-exchange debt.

V. Additional Provisions in IFI Loans to Restrain Excessive Borrowing

Past debt reductions have too often been followed by a new cycle of excessive borrowing and a new accumulation of unsustainable debt. To restrain future excessive borrowing, we propose that the IFI loans to the government contain the following provisions:

A. Full Debt Transparency

The government will covenant to publish complete data on all of its direct and guaranteed debt and debt-equivalent instruments. The debt and debt-equivalent instruments of State-Owned Enterprises will also be publicly disclosed. The government will covenant that future direct and guaranteed debt and debt-equivalent instruments will not contain confidentiality/non-disclosure provisions.

B. Restriction on Secured and Collateralized Financing

The government will covenant that future direct and guaranteed debt and debt-equivalent instruments will be unsecured with the exception of trade finance and stand-alone project financing. This restriction will include the dedication of cash-flows and output from commodity production to secure financing.

C. Mandatory Prepayment of IFI Loans

The government will covenant that should it incur non-concessional, foreign currency-denominated financing during the period while the IFI loans are outstanding, a specified percentage of the proceeds of that new non-concessional borrowing (we would suggest 10 percent) will be applied toward the prepayment of the IFI loans that facilitated these Structures.

The principal objective of this feature would be to discourage the beneficiary country from using the debt relief being provided by these Structures as a basis for again bulking up on excessive non-concessional borrowings. That, as both the Brady Plan and the HIPC Initiative demonstrated, has been one of the glaring shortcomings of sovereign debt architecture over the last 30 years and has fueled the boom/bust nature of lending to emerging market sovereigns.

Both the legacy debtholders and the IFI lenders should benefit from this mandatory prepayment feature; the former because it will tend to reduce the risk that the debtor country will again be catapulted into another debt crisis as a result of imprudent borrowing, the latter because any return to such behavior will precipitate early repayment of their loans and reduce their own exposure to the country.

Non-compliance with these provisions will be an event of default under the IFI loans. The IFI can temporarily waive an event of default under their loans to allow the government to come into compliance with these provisions.

Appendix

Summary of Terms and Conditions

A. Bond Exchange with Cash Down-Payment

Nominal Amount of Original Bonds Subject to Exchange:	US$ 10 billion (entire external bond stock)
Terms of Bond Exchange:	Bondholders will exchange their Original Bonds for a Cash Down-Payment plus New Bonds.
Cash Down-Payment Received upon Exchange:	10% of the nominal amount of the Original Bond (US$ 1 billion total)
Nominal Amount of New Bond Received upon Exchange:	90% of the nominal amount of the Original Bond (US$ 9 billion total)
Interest Rate of New Bond:	3-3.5% per annum
Maturity of New Bond:	25-30 years
Amortization of New Bond:	1/3 in each of the last three years prior to maturity
Activation of Collective Action Clauses in Original Bonds:	The collective action clauses in the Original Bonds will be activated upon attaining the requisite super-majority bondholder acceptance to force the exchange of residual holdings of the Original Bonds.

B. Bond Exchange with Rising Floor of Support for the New Bonds

Nominal Amount of Original Bonds Subject to Exchange:	US$ 10 billion (entire external bond stock)
Terms of Bond Exchange:	Bondholders will exchange their Original Bonds for New Bonds.
Cash Down-Payment Received upon Exchange:	None
Nominal Amount of New Bond Received upon Exchange:	100% of the nominal amount of the Original Bond (US$ 10 billion total)
Interest Rate of New Bond:	3-3.5% per annum

Maturity of New Bond:	35-40 years (fixed at time of operation to match maturity of World Bank Zero-Coupon Bond under the New Bond Exchange Feature below)
Amortization of New Bond:	Bullet maturity
New Bond Exchange Feature:	The holder of the New Bond will have the ability to exchange its New Bond for a World Bank Zero-Coupon Bond of identical nominal amount (redemption amount) and maturity on a quarterly basis.
World Bank Zero-Coupon Bond under New Bond Exchange Feature:	Nominal Amount: US$ 10 billion (entire external bond stock) Interest Rate: 0% Maturity: 35-40 years (time period corresponding to a market value of 20% of nominal amount for the World Bank Zero-Coupon Bond based upon the market interest rate for a World Bank Zero-Coupon Bond at the time of the launch of the operation)
Purchase of World Bank Zero-Coupon Bond:	At the time of the launch of the operation, the government will purchase the World Bank Zero-Coupon Bond from the World Bank on market terms. The market cost of funds of the World Bank for the Zero-Coupon Bond will determine the maturity of the World Bank Zero-Coupon Bond corresponding to the 20% of nominal amount purchase price. The entire World Bank Zero-Coupon Bond will be purchased by the government. No World Bank Zero-Coupon Bonds will be purchased by investors.
World Bank Zero-Coupon Bond Held in Trust for Bondholders:	The World Bank Zero-Coupon Bond will be held in trust for the benefit of the holders of the New Bonds. This is the structure used for the US Treasury zero-coupon bonds in the Brady Bond restructurings.
Payment of World Bank Zero-Coupon Bond Proceeds at Maturity to New Bond Holders:	At the maturity of the New Bonds, the redemption proceeds of the World Bank Zero-Coupon Bond will be paid directly to the holders of the New Bonds to meet the repayment obligation under the New Bonds.
Cancellation of New Bond upon Exchange:	Upon exchange of a New Bond for a World Bank Zero-Coupon Bond, the New Bond will be surrendered by its holder and will be cancelled with the exception of an exchange after a payment default. (See New Bond Holder Claim upon Payment Default below.)

New Bond Holder Claim upon Payment Default:	Upon a payment default that is not cured with 90 days and acceleration of the New Bonds, the New Bond holder claim is (par + accrued interest). If a bondholder exchanges its New Bond for a World Bank Zero-Coupon Bond after the 90-day cure period has ended and the New Bonds have been accelerated, the market value of the World Bank Zero-Coupon Bond will be considered a partial recovery of the bondholder's claim. The bondholder will then have a residual claim against the government of: ((par + accrued interest) - market value of World Bank Zero-Coupon Bond at time of exchange).
Activation of Collective Action Clauses in Original Bonds:	The collective action clauses in the Original Bonds will be activated upon attaining the requisite super-majority bondholder acceptance to force the exchange of residual holdings of the Original Bonds.