January 17, 2025

Thomas Laryea is an international law and policy expert at Orrick, Herrington & Sutcliffe. He specializes in representing governments and creditors in international finance and restructurings.

A Proposed Novel Approach to Sovereign Debt Restructuring

The deterioration of public debt dynamics remains a concern in international policy and market circles. Notably, in the most recent Annual Meetings of the International Monetary Fund and the World Bank Group, the IMF Managing Director's curtain-raiser speech highlighted that the confluence of high public debt (around 100% of global GDP), high interest rates, and low growth come together, creating risks for the global economy, but with a disproportionate burden on low-income countries. HERE

There are no one-size-fits-all solutions in this space. The dynamics of the public debt problems and the feasibility of tools to address them are not equally distributed across each country and its respective creditors. As I have argued elsewhere, radical attention is needed to address the liquidity challenges of some lower-income countries in a manner that allows them to scale up private financing for climate mitigation and adaptation. HERE

But in this current piece, I present a more modest, but potentially far-reaching, proposal for a new approach to sovereign debt restructuring, as an addition within the consensual and market-oriented tool kit. The essential proposition is this: All sovereign debt restructurings—whether in liquidity or unsustainable debt situations—involve a balance between (i) economic policy adjustment and (ii) financing in the form of new money and/or debt relief. Irrespective of where that balance is struck in any given case, the projected outcome is fundamentally contingent on the implementation of a range of economic policies (including institutional and legal reforms) by the debtor country. This is not to say that the problem and solution rests all on the debtor country. Rather, the point is that the debtor country's contribution through feasible adjustment is a necessary part of the sustainable resolution of any sovereign debt problem. The resolution is not just a prediction about whether the debtor country will make the restructured debt payments, but whether it will sustain economic policies that will contribute to its underlying debt payment capacity. This point is well highlighted in the press release of the Eurobond holders in Ghana's recent restructuring of its $13.5 billion international bonds. HERE

If the proposition is correct that debt sustainability, including the capacity to sustain the restructured payment terms, is dependent on debtor country policy implementation, then one might wonder how this contingency is reflected in the sovereign debt restructuring legal architecture. The answer is that this is generally not the case. We have seen use of value recovery mechanisms and other types of contingent instruments in some sovereign debt restructurings. For example, in the Suriname debt restructuring, the parties recognized that the IMF Debt Sustainability Analysis (as the methodology for assessing the balance between adjustment and financing) did not take into account the prospect of material proceeds from the development of Suriname's energy sector. Accordingly, the value recovery mechanism was designed, if the energy sector proceeds materialized, to compensate Suriname's bondholders for the unconditional relief that they were providing on the bonds. HERE In contrast, the design of the contingent instrument entailing the so-called macro-linked bond in the Sri Lanka debt restructuring bridged differences in views on Sri Lanka's projected GDP, one of the key inputs in the Debt Sustainability Analysis. HERE

However, these examples from the Suriname and Sri Lanka restructurings do not provide an answer to the general contingency of the debtor country contributing its part of the deal through policy implementation. The legal and financial engineering in these cases is designed to mitigate the problem that pre-fixing the delivery of debt relief exposes creditors to the risk that the debtor country might "overperform" on the projected economic outturns and thus will disproportionately capture the upside, implying that the creditors would have given up more relief than proved necessary. But these cases do not address the converse downside risk that pre-fixing the delivery of relief exposes creditors to the risk that the sovereign "underperforms", which could act as a drag on the value of the restructured claims and potentially result in the debtor coming back for even more relief. This downside risk is also not addressed by contingent instruments that provide specific (additional) debt relief in the event of an exogenous shock, such as a natural disaster event—see, for example, the relief triggered on Grenada's bond due to the effects of hurricane Beryl. HERE

If the generalized downside risk is a material concern, why have creditors been willing to provide unconditional relief? Perhaps one reason is that the debtor and its creditors may both value certainty in terms of the restructuring debt terms. But I believe that part of the reason is that we haven't innovated to find a better way to address the downside risk attendant to the policy-dependency of the debtor country's payment capacity.

Before I go any further, rest assured that I am not advocating the universal use of contingent instruments in every sovereign debt restructuring. Rather, my alternative approach, in cases where the debtor country and relevant creditors agree, is that the creditors would contractually commit to deliver progressive segments of debt relief automatically on condition that the debtor meets identified economic outturns tied to the relief delivery points over time. This is not the same as the approach recently used for the governance-related contingent instrument in the Sri Lanka debt restructuring where (separate from the macro-linked bond) the governance-related contingency would give Sri Lanka additional relief if the conditions were met, rather than allowing Sri Lanka only to lock in relief if the conditions are met.

In my proposal, the terms of the restructuring would need to identify the agreed third-party verifier for assessing the economic outturns during the time horizon in which relief is deliverable. This approach is more robust than creditors simply requiring that the debtor country's economic program remain assessed by the IMF to be "on track," as such a test can internalize IMF proclivity to allow the program targets to down-slide after debt relief has been locked in. Moreover, the third-party verifier logically should not be the IMF, as the debtor country and its creditors could not assume that an IMF financing program would be in place (or that IMF surveillance would provide the appropriate proxy) during the time in which debt relief is agreed to be deliverable.

My proposal would still allow the debtor country and its creditors to reflect the IMF's forward-looking assessment of the feasible economic adjustment path in their agreed-upon restructuring terms. And from the IMF's perspective, at the time the restructuring deal is reached, the IMF would be able to project into its Debt Sustainability Analysis the agreed conditional relief as if it were already delivered, since the condition for delivery is simply that the debtor country will achieve the projected economic outturns. Accordingly, the IMF would continue to play a critical role in assessing the feasible economic adjustment path at the time such a restructuring deal is reached.

While my proposal would optimize the incentives for the debtor country to meet its side of the restructuring bargain, what would be in this for the debtor country? My proposed approach could reduce the friction and thereby accelerate the conclusion of sovereign debt restructurings and make the restructurings outcomes more durable, all of which would inure to the benefit of debtors and creditors alike.

Although I envision that this proposal would be particularly useful in restructurings between a debtor country and bondholder creditors, there is no *ex-ante* reason why the core of my proposed approach could not be used in restructurings with other commercial and government creditors as well. It would expand the available tool kit, especially for addressing illiquidity situations in low-income and middle-income country cases at this time when there is a high premium to crisis mitigation, before crisis resolution becomes the only option.