Follow-up on the High-Level Event on Financing for Development in the Era of COVID-19 and Beyond
Discussion Group V: “Private Sector Creditors Engagement”
Background Document

Menu of policy options
The menu of options is organized in two broad categories: a) the immediate liquidity response; and b) solutions to achieve debt sustainability while creating fiscal space to invest in the SDGs. They include:

Immediate response
- Incentivize private sector creditors to participate in initiatives toward creating fiscal space for countries affected by the crisis
  - Further discussion with IIF and rating agencies on debt sustainability
  - Discussions with the IIF and other private actors, official creditors, and rating agencies on solutions such credit enhancements and blended finance
  - A voluntary credit facility including a guarantee of equal treatment and enhanced seniority of claims to incentivize participation
  - An asset purchasing programme (for countries with market access) such as an SPV to provide liquidity (e.g. ECA proposal).
  - Advocacy

- Extending the participation in the DSSI to include other vulnerable countries
  - Expansion of eligibility to include highly indebted vulnerable developing countries that request it (see also Group IV)

Debt Relief and solutions to achieve debt sustainability
- Legal support to developing countries, which could be a new institution or a voluntary effort, similar to Tax Inspectors without Borders
- A debt buyback facility to buys discounted debt in the secondary market (savings could go towards Covid or SDG investments)
- Debt Swaps to invest in Covid-or SDG investments like climate resilience
- Reprofiling of debt e.g. to include state contingent elements, which could include credit enhancements
- An asset purchasing programme or facility/reprofiling with a credit enhancement, including for domestic debt, to write-down debt
Detailed proposals

Background
COVID-19 and its economic fallout are devastating to public balance sheets and are further exacerbating already high debt risks. The international community has taken action to provide relief – through the G20 debt service suspension initiative (DSSI), and debt relief by the IMF for 25 countries. While these represent a critical first step, around 18 per cent of these countries’ debt is owed to commercial creditors (up from 5 per cent in 2010). Around $13 billion is owed through the remainder of this year. Overall, 69 per cent of developing countries’ debt is owed to commercial creditors (compared to 41 per cent in 2010).

It is ultimately in commercial creditors’ collective interest to help countries navigate this liquidity crisis. A liquidity problem could transform into a solvency crisis. Nonetheless, it can be difficult to bring all private creditors together. There is no established mechanism to ensure full private sector participation, diverse commercial incentives and obligations can make voluntary participation in coordinated initiatives unattractive or difficult, and individual creditors may benefit from holding out.

The menu of options is organized in two broad categories: i) the immediate liquidity response; and ii) solutions to achieve debt sustainability while creating fiscal space to invest in the SDGs.

1. The immediate response:

Incentivizing private sector participation in initiatives to create fiscal space for countries affected by the Covid-19 crisis, including through further discussion with the IIF and rating agencies

• **Further discussion with the IIF and rating agencies:** The DSSI should improve countries’ debt sustainability by providing needed liquidity. Markets are forward looking, and in the medium-term, borrowing countries should come out of the program with stronger credit than if they had not participated. The IIF terms of reference aim to structure the suspension so as not to trigger a downgrade or cross-default clauses. It has also prepared a draft waiver for such clauses in commercial debt contracts. Discussion could also focus on other ways to provide liquidity.

• **Enhance participation through a voluntary credit facility.** In this proposal, an international financial institution with preferred creditor status (the World Bank or a regional development bank) would open a credit facility for participating countries. Official and commercial creditors would be encouraged to reinvest interest payments falling due on their existing credits in the facility. Incentives for participating private creditors include a guarantee of equal treatment and enhanced seniority of claims.

• **Use of necessity defense.** Necessity is a rule of customary international law that excuses nonperformance of international obligations (arguably, servicing of commercial debt during a pandemic) when that is required to safeguard an “essential interest against a grave and imminent peril” which is beyond the state’s control. Countries could invoke necessity in defense against a lawsuit filed by holdout creditors that do not participate in the moratorium. Any such lawsuits would, however, at least temporarily impact credit ratings and market access, independent of their ultimate outcome.

• **An asset purchasing programme to help maintain market access (for countries with market access).** There are many forms such programs could take. For example, the African Union has suggested
creating a Special Purpose Vehicle to subsidize private sector investment in African sovereign dollar debt. This could include a guarantee from MDBs as part of debt relief.

**Expansion of eligibility of beneficiary countries.** To include highly indebted vulnerable developing countries that request it (see also Group IV).

2. Debt relief, improvements to the debt and financial architecture

**Debt relief:** Debt sustainability will need to be reassessed after the initial crisis period and the DSSI moratorium period. Debt relief may be needed to avoid widespread defaults and to facilitate investments in recovery and the SDGs. There are several mechanisms that could be used to give countries some relief, short of a default.

- **A fund to buy back outstanding stock of external debt issued on commercial terms.** Debt would be bought at a discount, based on market prices, thus providing relief to the debtor without restructuring. Care must be taken not to inflate prices in secondary markets, e.g. by setting a price ceiling. This could be done either by countries individually or through a buy-back facility (similar to the Debt Reduction Facility accompanying HIPC). Financing saved could then be used for a Covid response or SDG investments.

- **Debt swaps.** ECLAC is working with governments in the Caribbean on an initiative that would use proceeds from a debt swap to fund investments in climate change resilience. Swaps could also include swapping outstanding debt into Covid/SDG bonds, for which standards could be developed.

- **Reprofiling of debt.** Debt could also be swapped into instruments that better share risk, such as state-contingent debt; this could include credit enhancements.

**Capacity support:**

- **A legal support facility** to provide financial support for legal assistance to vulnerable developing countries. This could be a new entity, or a voluntary approach, similar to tax inspectors without borders.

**Sovereign debt restructuring architecture:** There are several proposals that have been developed over the years to improve the international debt architecture, ranging from market-based mechanisms to more statutory approaches. These include:

- **Continued improvements to market-based approaches.** This could include continued strengthening of collective action clauses. Somewhat stronger proposals include significantly raising the percentage of bondholders needed to vote for debt acceleration, or allowing the supermajority of bondholders to impose rules that proceeds from holdout litigation would be shared by all bondholders, similar to syndicated bank loans. Meanwhile, private creditors have also developed strategies to circumvent these contractual changes. Another market-based approach would be **greater use of state-contingent debt instruments** (e.g. hurricane clauses or GDP-linked bonds), which help countries better manage short term liquidity needs and stabilize long-term expenditures.

- **Legal and legislative strategies,** e.g. **extension of national legislation** to limit litigation by uncooperative creditors; or reinterpretation of existing legislation. Legislation can be introduced
or changed unilaterally without the creation of new intergovernmental mechanisms. However, a critical mass of major economies would be required to have this kind of legislation in order to make such strategy work.

- **Further development of soft law principles**, including both principles of responsible borrowing and lending, as well as for fair restructuring.

- **Establishing a sovereign debt forum**, which would provide a platform for discussions between creditors and debtors, in the context of SDG debt relief. It could facilitate further steps such as: agreements on voluntary stays; coordinated rollovers such as in the Vienna Initiative; and other measures.

- **Proposals for statutory approaches ranging from arbitration or mediation to a sovereign debt restructuring mechanism (SDRM)** would bring together creditors from across creditor classes. However, it faces challenges, including limited political support.

**Strengthening local capital markets**, given the growth in domestic debt in many countries, some countries are facing debt distress due to domestic debt overhangs. Domestic debt is usually issued under national law and in the domestic currency, so that restructurings have a different profile than restructurings of external debt. Nonetheless, domestic debt distress can be extremely challenging for policy makers. In many countries the bulk of government debt is held by commercial banks, so that the government might be forced to bail out the banking sector in the event of a restructuring. Some of the proposals above can also be used for domestic debt (e.g. reprofiling of debt). In addition, the Addis Agenda calls for improving domestic bankruptcy regimes to clarify rules for restructuring in the event of debt distress. (See Addis commitments below.)
Annex: Financing for Development outcomes on sovereign debt (relevant to private creditors)

The Financing for Development outcomes (Monterrey Consensus (MC), Doha Declaration (DD), and the Addis Ababa Action Agenda (AAAA)) contain actions and commitments on debt sustainability:

**Principles of shared responsibility:**
- Debtors and creditors must work together and share the responsibility for preventing and resolving unsustainable debt situations. [MC para 47; AAAA 97]; Maintaining sustainable debt levels is the responsibility of the borrowing countries; however, lenders also have a responsibility to lend in a way that does not undermine a country’s debt sustainability. [AAAA 97]
- We will work towards a global consensus on guidelines for debtor and creditor responsibilities (and fair burden sharing) in borrowing by and lending to sovereigns, building on existing initiatives. [MC 51, AAAA 97]

**Debt sustainability analysis, transparency, and links to global goals/the SDGs:**
- We need to strengthen information-sharing and transparency for debt sustainability assessments [DD 65; AAAA 96]
- Debt sustainability frameworks should give due weight to the development needs of debtor countries, including benefits from expenditures and investment that have long-term social and economic returns. [Doha 66]

**External shocks**
- We encourage consideration of further debt relief steps, where appropriate, and/or other measures for countries affected by external shocks, as feasible. [AAAA 102]
- We stress the need to consider fundamental changes in debt sustainability caused by natural catastrophes, severe terms of trade shocks or conflict, when making recommendations, including for debt relief, as appropriate. [MC 50]

**Legislation**
- We note legislative steps taken by certain countries to prevent these activities and encourage all Governments to take action, as appropriate. [AAAA 100]
- We welcome provision of financial support for legal assistance to least developed countries and commit to boosting international support for advisory legal services. We will explore enhanced international monitoring of litigation by creditors after debt restructuring. [AAAA 100]
- We note the increased issuance of sovereign bonds in domestic currency under national laws, and the possibility of countries voluntarily strengthening domestic legislation to reflect guiding principles for effective, timely, orderly and fair resolution of sovereign debt crises. [AAAA 101]

**Domestic Debt**
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**Principles for debt restructuring**
- Debt restructurings should be timely, orderly, effective, fair and negotiated in good faith [AAAA 98] with equivalent treatment of all creditors, just treatment of creditors and debtors, fair burden sharing, and legal predictability in debt resolution. [MC 51, DD 58, 60]
- A workout from a sovereign debt crisis should aim to restore public debt sustainability, while preserving access to financing resources under favourable conditions. [AAAA 98]
- We encourage efforts towards a durable solution to the debt problems of developing countries to promote their economic growth and sustainable development. [AAAA 98]
- We further acknowledge that successful debt restructurings enhance the ability of countries to achieve sustainable development and the sustainable development goals [AAAA 98]; Debtors’ national policies and strategies linked to attaining the internationally agreed development goals should be taken into account [DD 63]