INTERNATIONAL MONETARY FUND

June 2014

THE FUND'S LENDING FRAMEWORK AND SOVEREIGN DEBT—PRELIMINARY CONSIDERATIONS

IMF staff regularly produces papers proposing new IMF policies, exploring options for reform, or reviewing existing IMF policies and operations. The following document has been released and is included in this package:

- The **Staff Report** prepared by IMF staff and completed on May 22, 2014 for the Executive Board's consideration on June 13, 2014.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

Electronic copies of IMF Policy Papers
are available to the public from
http://www.imf.org/external/pp/ppindex.aspx

International Monetary Fund
Washington, D.C.

©2014 International Monetary Fund

INTERNATIONAL MONETARY FUND

May 22, 2014

THE FUND'S LENDING FRAMEWORK AND SOVEREIGN DEBT—PRELIMINARY CONSIDERATIONS

EXECUTIVE SUMMARY

Background. As a follow-up to the Executive Board's May 2013 discussion, this paper considers a possible direction for reform of the Fund's lending framework in the context of sovereign debt vulnerabilities. The primary focus of this paper relates to the Fund's exceptional access framework, since it is in this context that the Fund will most likely have to make the difficult judgment as to whether the member's problems can be resolved with or without a debt restructuring. The objective of the preliminary approaches set forth in this paper is to reduce the costs of crisis resolution for both creditors and debtors—relative to the alternatives—thereby benefitting the overall system. These ideas are market-based and their eventual implementation would require meaningful consultation with creditors.

Nature of the problem. The Exceptional Access Framework established in 2002 ("2002 framework") limits the range of policy responses available to the Fund when a member seeks financing above normal access limits in the context of a sovereign debt crisis. Specifically, under the 2002 framework, if the Fund determines that the member's debt is sustainable with high probability, it may provide large scale financing without the need for a debt restructuring. However, if such a determination cannot be made, exceptional access may only be provided if a debt restructuring is pursued that is sufficiently deep to restore sustainability with high probability. While the 2002 framework was designed to address concerns regarding both moral hazard and the cost of delaying the restructuring of unsustainable debt, this paper concludes that it also created scope for unnecessary costs for both the debtor and its creditors, since it requires a definitive debt restructuring even in circumstances where, in the end, it might not be needed.

Possible remedy. The preliminary ideas in this paper would introduce greater flexibility into the 2002 framework by providing the Fund with a broader range of potential policy responses in the context of sovereign debt distress, while addressing the concerns that motivated the 2002 framework. Specifically, in circumstances where a member has lost market access *and* debt is considered sustainable, but not with high probability, the Fund would be able to provide exceptional access on the basis of a debt operation that involves an extension of maturities (normally without any reduction of principal or interest). Such a "reprofiling" operation, coupled with the implementation of a credible adjustment program, would be designed to improve the prospect of securing sustainability and regaining market access, without having to meet the criterion of restoring debt sustainability with high probability.

Safeguarding the catalytic role. The possible modifications would preserve the effectiveness of the Fund's traditional catalytic role—there would be no presumption that a reprofiling would be required simply because a member seeks Fund support. Rather, a reprofiling would be envisaged only when both (a) a member has lost market access and (b) debt is assessed to be sustainable, but not with high probability. Conversely, in circumstances where a member's debt is unsustainable, a reprofiling would be inappropriate and an upfront debt reduction operation would be pursued, as under current policy. A debt reduction would also be called for if a reprofiling operation failed to dispel concerns regarding debt sustainability—i.e., repeat reprofilings would be avoided.

Benefits. Where there is considerable uncertainty as to whether debt is sustainable or unsustainable, a reprofiling will generally be less costly to the debtor and creditors—and thus to the system overall—relative to either an upfront debt reduction operation or a bail-out that is followed by debt reduction. Moreover, relative to a bail-out, the financing that will be provided through the reprofiling could allow for more gradual adjustment paths, which would help growth, reduce economic dislocation and facilitate successful program implementation.

Securing creditor support. As with other types of debt restructuring supported by the Fund, a reprofiling will be market-based. Accordingly, a reprofiling would require the sovereign's creditors to agree to amend the terms of the instruments to extend maturities. Creditors will only agree if they understand that such an amendment is necessary to avoid a worse outcome: namely, a default and/or an operation involving debt reduction. This will require consultation with creditors, including an explanation of the assumptions that underpin the member's debt sustainability analysis. Collective actions clauses, which now exist in most—but not all—bonds, would be relied upon to address collective action problems. Official creditors would be expected to maintain their exposure either through an extension of maturities or provision of new financing.

Systemic exemption. Under the possible modifications, the systemic exemption to the 2002 framework that was introduced in 2010 would be eliminated. The exemption is perceived to be inequitable and excessively open-ended. Moreover, experience demonstrates that, since contagion is exacerbated by uncertainty, a large scale bail-out that fails to address underlying concerns regarding sustainability will not mitigate contagion risks. It is recognized that there may be circumstances where any form of debt restructuring—an upfront debt reduction or a reprofiling—would be considered problematic from a contagion perspective. The paper considers that, in these cases, sustainability concerns could be addressed not through a debt restructuring but through concessional assistance provided by other official creditors.

Ex ante effects. Since the revised framework would continue to rely on case-by-case judgments on the extent to which a member's debt is sustainable or unsustainable, the impact of the possible reforms will largely depend on how they are applied in practice. It is unlikely that the possible modification would affect countries' steady-state

borrowing costs, since investors tend to rely primarily on the creditworthiness of the borrower when pricing risk. However, in the context of debt distress of a particular member, it is possible that creditors may demand higher rates on shorter-term debt if they perceive that the modifications would reduce the probability of a bail-out. If this is the case, it can be seen as a healthy development since it will lead to a better pricing of risk.

Normal access. Although many of the benefits from reprofiling may apply equally in normal access cases when debt sustainability is in doubt, the paper does not consider making it a requirement in normal access cases where there is uncertainty regarding debt sustainability. The paper suggests, however, that a policy be established to avoid the repeated use of reprofilings in normal access cases, in line with the approach considered under exceptional access. If a reprofiling does not work, it would suggest that a definitive solution to the member's debt problem is called for.

Approved by

Olivier Blanchard, Sean Hagan, Siddharth Tiwari, and José Viñals

This paper was prepared by a team from four departments led by Reza Baqir. The team comprised Yan Liu (LEG lead), Julianne Ams, Wolfgang Bergthaler, Chanda DeLong, Nikita Aggarwal, Hoang Pham, Gomi Otokwala, and Natalia Stetsenko (all LEG); Luc Everaert (MCM lead), Michael Papaioannou, Miguel Segoviano, Kay Chung, Anastasia Guscina, and Gabriel Presciuttini (all MCM); Luc Laeven (RES lead), Marcos Chamon, Raquel Fernandez, Alberto Martin, Romain Ranciere, and Damiano Sandri (all RES); and Geneviève Verdier and Varapat Chensavasdijai (SPR leads), Athanasios Arvanitis, Tamon Asonuma, Alexander Culiuc, Christopher Dielmann, Heiko Hesse, Sarwat Jahan, Charlotte Lundgren, Alex Pienkowski, Francisco Roch, Stephanie Segal, Cesar Serra; Preya Sharma, Nelson Sobrinho, Yan Sun-Wang, Suchanan Tambunlertchai, and Yi Xiong (all SPR). The work was supervised by Olivier Blanchard, Sean Hagan, Hugh Bredenkamp, and Peter Dattels.

CONTENTS

I. INTRODUCTION 6

II. THE FUND'S EXCEPTIONAL ACCESS FRAMEWORK—UNDERSTANDING THE PROBLEM AND THE OBJECTIVES OF POTENTIAL REFORM 8

A. The nature of the problem 8

B. A possible remedy 11

C. Costs and benefits of the possible remedy 12

D. Addressing contagion concerns 18

E. Potential *ex ante* effects 21

III. DESIGN AND IMPLEMENTATION ISSUES 22

A. When should a reprofiling take place? 22

B. The length of the reprofiling period and the scope of debt to be covered 25

C. The design of the Fund-supported program 26

D. Securing creditor support 27

E. Resolving collective action problems 29

F. Implications for the normal access framework 31

G. Clarifying the market access criterion 32

IV. ISSUES FOR DISCUSSION 32

References 41

BOXES

1. Exceptional Access Criteria ____ 33
2. Relationship Between Creditor Losses and Duration of Market Access Loss ____ 34
3. Impact of Sovereign Debt Maturity Extensions on Domestic Bank Balance Sheets ____ 35
4. Debt Reprofiling in Past Fund-Supported Programs ____ 36
5. Contagion in Past Restructuring and Reprofiling Cases ____ 38
6. A Framework for Assessing Market Access Loss ____ 40

FIGURES

1. Median Bond Yields Before and After Restructuring Announcement ____ 15
2. Length of S&P Selective Default Rating ____ 15
3. Reprofiling and Face Value Reduction: Time to Market Reaccess ____ 16
4. Assessment of Debt Sustainability, Market Access, and Fund Lending ____ 24

I. INTRODUCTION

1. As a follow-up to the Executive Board's May 2013 discussion, this paper discusses the relationship between the Fund's lending framework and sovereign debt vulnerabilities and, in that context, provides preliminary considerations regarding a possible direction for reform.[1] A separate paper will examine potential areas of reform in the contractual framework that would address collective action problems that may arise in the context of debt restructuring. That paper will be issued for discussion as soon as ongoing consultations with creditors regarding the design features of these contractual provisions are complete. As agreed, future work will also include an examination of official sector involvement in sovereign debt restructuring and a review of the Fund's lending-into-arrears policy.

2. The primary focus of this paper relates to the design of the Fund's exceptional access policy. A member facing a crisis arising from its inability to service its debt typically has large financing needs. It is therefore not surprising that it is in the exceptional access context that the Fund typically finds itself having to make the difficult judgment as to whether the member's problems can be resolved with or without a debt restructuring. Moreover, given the heightened risk to the Fund that arises from the granting of access above the normal limits ("exceptional access"), it is also not surprising that it is in this context that the Fund has sought to identify ex ante criteria to guide its discretion. Indeed, the exceptional access framework established in 2002 sought to provide both substantive and procedural guidance on how these issues should be considered by the Fund. While an important element of this framework was modified in 2010, this modification was not accompanied by an in-depth assessment of the 2002 framework, and staff is of the view that such an analysis is overdue. In particular, and as will be discussed in this paper, the 2010 amendments revealed certain rigidities in the 2002 framework that require broader consideration. These rigidities do not exist in the policy governing normal access decisions, and hence the paper concludes that the possible modification be primarily addressed to exceptional access cases.

3. The analysis set forth in this paper has been guided by the Executive Directors' request for staff to "approach these issues with an open mind and pragmatism, finding the right balance between flexibility and predictability." Consistent with this guidance, the staff has taken into account several principles that would guide any reform discussions.

- First, when a member encounters sovereign debt distress manifested by a loss of market access, it is critical that the Fund be in a position to provide large-scale financing in circumstances where it reaches a judgment that a combination of strong adjustment measures and financial assistance from the official sector will restore market confidence and access and enable the member to service its obligations in full. Preserving this traditional catalytic function is critical

[1] See *Sovereign Debt Restructuring—Recent Developments and Implications for the Fund's Legal and Policy Framework*.

not only because it limits economic dislocation and financial instability in the member's economy, but also because it has long-term benefits for the stability of the international monetary system, including by protecting the creditor-debtor contractual relationship and preserving sovereign debt as an important asset class. Accordingly, there should be no hard, pre-specified limits on the amount of financing that can be provided to a member. Furthermore, debt restructuring should not be relied upon in circumstances where the member is facing a temporary loss of market access and where concerns regarding debt sustainability are limited. For all of the above reasons, when a member facing financing pressures approaches the Fund, there should be no "presumption" that any Fund assistance will be made conditional upon any form of debt restructuring.

- Second, when considering how to address problems of sovereign debt sustainability, the Fund should seek solutions that are least costly to the member, its creditors, and the overall system—and which protect the interests of the Fund as a financial institution. Where debt is sustainable with high probability, the catalytic approach represents the most effective way of achieving these objectives. However, in circumstances where debt is unsustainable, a debt restructuring that restores sustainability should take place as soon as possible. While debt restructuring always entails costs, delaying a restructuring that is judged to be inevitable will often simply exacerbate costs. As will be discussed in this paper, a key challenge is how to minimize costs in circumstances where there is uncertainty as to whether a member's debt is sustainable or unsustainable.

- Third, when the Fund makes judgments in this area, they should continue to be made on a case-by-case basis—i.e., they should remain judgments. While—as with other policies—it is appropriate that these judgments be based on the application of general criteria established by the Executive Board, these criteria should be designed to guide—but not eliminate—the exercise of discretion.

- Finally, there should be adequate creditor consultation during the restructuring process. Creditors will only agree to a restructuring when they understand that it is in their interest to do so. Accordingly, it is important that the Fund support a process whereby creditors have adequate information with respect to both the nature of the member's problems and the elements of the Fund-supported program that is designed to address them. While the modalities of this engagement will vary, taking into consideration the circumstances of the case, it is important that there be sufficient transparency, including with respect to the relevant debt sustainability analysis. "Take-it-or-leave-it" offers (i.e., where there is no meaningful consultation with creditors) should be avoided.

4. It is recognized that balance of payments crises can also arise from over-indebtedness in the banking, corporate and household sectors. The Fund has devoted considerable efforts in helping the membership design and implement frameworks that restructure the debt of these sectors. These efforts include not only reforms that are designed to implement the *Key Attributes of Effective Resolution Regimes for Financial Institutions* but also reforms of the domestic corporate and household insolvency systems.[2] However, while the effective implementation of these frameworks would help limit the risk that indebtedness in these sectors of the economy will be transferred to the sovereign, they cannot be relied upon to restructure sovereign debt once it has become unsustainable.

5. The preliminary ideas set forth in this paper are market-based, and take a different approach than the one advanced by the Fund in 2003 for a sovereign debt restructuring mechanism (SDRM). As a means of reducing the costs that arise from unsustainable sovereign debt, the paper explores a targeted change to the Fund's lending framework to make it more flexible and calibrated to members' debt situations, taking it as given that any associated restructuring of debt would take place through market-based mechanisms. Consistent with the above, while the paper recognizes that collective action problems may complicate the restructuring process, it relies on a contractual—rather than statutory—solution to the problem. In preparing this paper, staff consulted informally with a broad range of market participants. The analysis that underpins the following considerations has benefitted from the input of these participants.

II. THE FUND'S EXCEPTIONAL ACCESS FRAMEWORK—UNDERSTANDING THE PROBLEM AND THE OBJECTIVES OF POTENTIAL REFORM

A. The nature of the problem

6. The key elements of the existing exceptional access policy were established in 2002 and were designed to address widespread concerns that the Fund's lending framework had been excessively permissive. Prior to 2002, the exceptional access policy was designed to be very flexible—and was implemented that way.[3] In circumstances where a member sought financing in excess of the established limits, the Fund had a policy of waiving the limits on the basis of "exceptional circumstances"—with no criteria as to what these circumstances were and why they should be considered particularly exceptional. As capital account crises arrived with greater

[2]Available via the Internet: http://www.financialstabilityboard.org/cos/cos_111001a.htm

[3]See Annex I for a historical review of the Fund's lending framework and exceptional access policy.

frequency during the 1990s, the Fund found itself invoking the exceptional access policy with greater frequency: while exceptional access was only granted on rare occasions during the 1980s, it was granted 14 times between 1995 and 2002 and some of the Fund-supported programs were unprecedentedly large. Concerns grew within the Fund—and within the official sector more generally—that the Fund's resources were simply being used to enable the sovereign to repay maturing debt obligations, and that these financing packages were generating moral hazard. Moreover, there was concern that, in some cases, a delay in debt reduction allowed some creditors to exit, requiring sharper debt reduction later on. Last, but certainly not least, large-scale Fund financing in these circumstances called into question the adequacy of safeguards for Fund resources. The Fund's decision to lend to Argentina in 2001, and the subsequent default of the country's debt, served as the final catalyst for a broad review of the Fund's exceptional access policy. This review culminated in the 2002 reform.

7. Central to the 2002 exceptional access framework is the requirement that "a rigorous and systematic analysis indicates that there is a high probability that the debt will remain sustainable." The consequences of this requirement are two-fold:

- First, where exceptional access is sought, the Fund may rely on its traditional catalytic approach—the provision of financing in a manner that enables the sovereign to service its original obligations—only where the Fund is very confident that this approach will work; i.e., where there is a high probability that the member's debt is sustainable. As a result of this approach, debt restructuring will be required not only in cases where there is a high probability of unsustainability, but also where it is not clear with a high probability whether the debt is sustainable or unsustainable; i.e., in cases where there is uncertainty.

- Second, in those cases where a determination is made that debt restructuring is necessary, it must be sufficiently deep to enable the Fund to conclude that, post restructuring, there is a high probability that the member's debt will become sustainable. Importantly, therefore, where debt restructuring is needed, the 2002 framework requires a definitive debt operation; i.e., one that entails a significant reduction in the net present value of claims.

8. In assessing the implications of the above approach, it needs to be recognized that, in the sovereign context, there will be occasions where there is uncertainty as to whether the member's debt is sustainable or unsustainable. As noted in the 2013 paper, recent improvements in the Fund's DSA framework will help to make sharper judgments with respect to debt sustainability. This will help to ensure that debt restructuring is timely—and sufficient—in those cases where it is clearly warranted. However, since debt sustainability assessments are not simply mechanical or data-driven, and because they are forward-looking, they will always require difficult judgments regarding a broad range of variables, including, for example, the medium-term growth path. Accordingly, no matter how rigorous a DSA is designed to be, there are likely to be instances where it will be difficult to conclude that there is a high probability of either sustainability or unsustainability.

9. Where there is uncertainty regarding debt sustainability, requiring debt restructuring that is sufficiently deep to restore sustainability with a high probability imposes costs that, in the end, may not be justified. No matter how orderly a debt restructuring operation is, it will impose costs. From a creditor's perspective, these costs are primarily the loss in the net present value of its claims, but also may include any spillover effects to other sovereign bonds or asset classes. From the sovereign's perspective, these costs range from a loss of market access over the medium term to disruptions in the financial sector, especially where the sovereign's debt is held by its banks. From the perspective of global financial stability, there is also the risk of contagion. In cases where a sovereign's debt is unsustainable, these costs need to be weighed against the costs of delaying a restructuring that has become inevitable. As was stated in the 2013 paper, the Fund has taken the position that, in such cases, it is in the interests of the sovereign, its creditors, the Fund and the overall system for the restructuring to absorb these costs earlier rather than later. However, in circumstances where there is uncertainty as to whether the debt is sustainable or unsustainable, the costs of a debt restructuring that involves a significant NPV reduction need to be assessed against the possibility that such a restructuring may not actually be needed; i.e., that a combination of strong adjustment and Fund financing will enable the member to service its obligations.

10. This problem came to the fore during the Fund's experience with the euro area programs. While the DSAs produced for these members did not conclude that debt was unsustainable, they were also not able to conclude that the debt was sustainable with a high probability. Under the terms of the 2002 policy, the only choice for the Fund would have been to condition Fund support on the implementation of a debt restructuring operation that was of sufficient depth to enable the Fund to conclude that, post restructuring, the member's indebtedness would be sustainable with high probability. Out of concern that an upfront debt restructuring operation would have potentially systemic effects, the Fund opted to amend the framework in 2010 to allow the requirement of determining debt sustainability with "high probability" to be waived in circumstances where there is a "high risk of international systemic spillovers."[4]

11. It has become clear that the systemic exemption established in 2010 does not provide a coherent long-term solution to the problem. The difficulty with the systemic exemption is that it is both too narrow and too broad. It is too narrow because it is only of benefit to those members that are sufficiently large or interconnected that debt reduction will have systemic consequences, whereas the rigidity in the policy potentially affects all members. It is too broad because it does not address the key concerns that gave rise to the 2002 framework; namely, in circumstances where there is uncertainty regarding the sustainability of a member's debt, there are costs to a framework that anticipates use of the resources of the Fund—and of the member—for the repayment of

[4]See Box 1 for the four exceptional access criteria that are currently applicable, incorporating the amendment made in May 2010.

maturing debt obligations to private creditors. As noted in the 2013 paper, in the event that a debt restructuring is required, this approach simply aggravates the problems for the member and also places the Fund's own resources at greater risk. Moreover, because of the limits on the availability of financing from the official sector, allowing for creditor exit imposes a greater burden on the fiscal adjustment process, which can undermine medium-term growth prospects and weaken political support for adjustment, thereby jeopardizing sustainability.

B. A possible remedy

12. In considering ways to address the above shortcomings, staff has focused on the possibility of making the 2002 framework more flexible so as to support a broader range of policy responses with regard to sovereign debt. The objective of the possible reform would be to enable the Fund to: (i) help the member improve its capacity to service its debt without necessarily requiring significant debt reduction while (ii) avoiding a situation where, notwithstanding concerns regarding debt sustainability, the program allows for the eventual full repayment of maturing obligations to private creditors. The existing systemic exemption established in 2010 would be eliminated and, as is described in Section II.D, alternative approaches could be considered when addressing the risk of contagion that may arise from a debt restructuring.

13. Under the approach considered in this paper, in circumstances where a member has lost market access and public debt is considered sustainable, but not with high probability, the Fund would be able to make its financing conditional upon a debt operation that, while improving debt sustainability, does not necessarily restore sustainability with high probability. Specifically, creditors would be requested to agree to a relatively short extension of maturities ("reprofiling"). A reprofiling would typically not involve a reduction in either principal or coupon and, in light of the fact that it would be of limited duration, would not imply a significant reduction in the net present value of creditors' claims. Because of its limited nature, such a debt operation would not necessarily restore debt sustainability with high probability (hence the need for a modification of the policy). However, it would be designed so that, when coupled with the implementation of a strong adjustment program, the member will still have good prospects of restoring market access without the need for debt reduction. Accordingly, the duration of the reprofiling would be determined on a case-by-case basis, taking into account the length of the program and the structure of the member's public debt. In accordance with current Fund lending policy, if, during the course of the program, it subsequently became clear that the reprofiling has not been sufficient to achieve the programmed improvement in the member's sustainability, further Fund support would be conditioned on a more definitive debt operation being carried out.

14. Such increased flexibility would be designed and implemented in a manner that safeguards the Fund's traditional catalytic approach; there would be no "presumption" that a member who approaches the Fund for a program after having lost market access would need to undertake any form of debt restructuring, including a reprofiling. Rather, even when a member has lost market access, the Fund would be able to rely on its traditional catalytic approach if it can make the determination that there is a high probability that debt is sustainable and that,

accordingly, the loss of market access is very likely to be temporary. Only if the Fund cannot make this determination would some form of debt restructuring be expected, the nature of which would depend on the circumstances. In particular, where it is relatively clear, based on a debt sustainability analysis, that the member's debt is *un*sustainable, a definitive debt reduction operation (as required under current policy) would remain the most appropriate way to address the problem. However, as will be argued further below, in circumstances where the member's debt is assessed to be sustainable but not with high probability, a reprofiling would typically be a more cost-effective way to give the member's adjustment program a good chance of restoring sustainability. Accordingly, whether a debt restructuring operation is needed, and if so, what type would be the most appropriate, will depend on the circumstances of the case and, in particular, a rigorous debt sustainability assessment.

15. Since reprofiling will be "voluntary"—inasmuch as it will involve bondholders agreeing to amend the terms of their instruments—creditors will only support such an operation if they conclude that it is in their interest do so. As with other forms of restructurings, a reprofiling will be achieved through an agreement among creditors (normally through an exchange) to amend their bonds to extend maturities. This process will need to address several issues. First, to address collective action problems, it will be important that collective action clauses be in place that enable a qualified majority to bind the minority. Second, the majority itself will only support an amendment if they consider it in their interest to do so. In this regard, some may take the view that, in an environment of uncertainty, they should avoid participating in a reprofiling that locks them into a debt reduction operation that is likely to occur in the future. For this reason, securing adequate creditor participation will require the Fund-supported program and the reprofiling to be sufficiently credible to give creditors reason to believe that a debt reduction operation is significantly less likely to be needed following a reprofiling. In this regard, it will be important that the Fund be in a position to assist the member in explaining to creditors the assumptions that underlie the program, the relevant debt sustainability analysis and, in particular, the size of the financing envelope that the reprofiling will need to deliver in order for the program to be successful. The Fund will need to make it clear that, in the absence of high participation in a reprofiling, the program will not proceed. These issues are discussed further in Section III.D below.

C. Costs and benefits of the possible remedy

16. The costs of reprofiling should be assessed against the costs that arise when, given significant uncertainty as to whether debt is sustainable or unsustainable, the Fund is forced to make the binary choice between debt reduction and allowing for creditor exit, as is the case under the current framework. More specifically:

- *Reprofiling as an alternative to debt reduction*. As noted earlier, in circumstances where a member's situation is uncertain, the cost of a debt restructuring operation that results in a significant reduction in the net present value of claims needs to be assessed in light of the possibility that, in the end, significant debt reduction is not, in fact, needed. Viewed from this perspective, there are several reasons why the cost of a reprofiling is likely to be less than that of debt reduction. First, since it will be designed to have a smaller impact on the net present

value of creditors' claims relative to a debt reduction, it will be less disruptive to the financial institutions of the member that hold these claims, as well as to foreign holders of such claims (see Section II.D on contagion issues). Second, and for similar reasons, although a reprofiling will result in a credit rating downgrade to selective default, the sovereign is likely to be able to return to capital markets more quickly following a reprofiling than after an operation that results in debt reduction (see Box 2). As will be described, reprofiling would be used only after market access is lost. A review of experience finds that (i) sovereign spreads have risen less, and returned to precrisis levels faster, in past face-value preserving maturity extensions that do not involve a significant NPV reduction (Figure 1); (ii) a credit rating downgrade to selective default has been short-lived in such operations, corresponding to the duration of the exchange offer (Figure 2); (iii) it appears to have taken longer, in general, for a member to re-access markets after a debt reduction than following such maturity extensions (Figure 3); and (iv) the impact on the domestic financial system has been limited in past face-value preserving maturity extensions (Box 3).[5] Annex III reviews this evidence in greater detail. These findings are not definitive, as market responses will have been conditioned on many factors other than the degree of NPV reduction—but they are at least indicative, and support the above analysis. They should not be construed as implying that reprofiling would always be received more positively than debt reduction: if markets believe that only debt reduction can restore sustainability, their reaction to a reprofiling effort could be more adverse. Moreover, one disadvantage of a reprofiling relative to a debt reduction operation is that it risks prolonging the debt overhang problem in the economy. Accordingly, and as will be discussed further below, reprofiling should not be used when debt is unsustainable (thereby requiring debt reduction) and should be applied only when it has a credible prospect—together with policy adjustment—of resolving the member's problems.

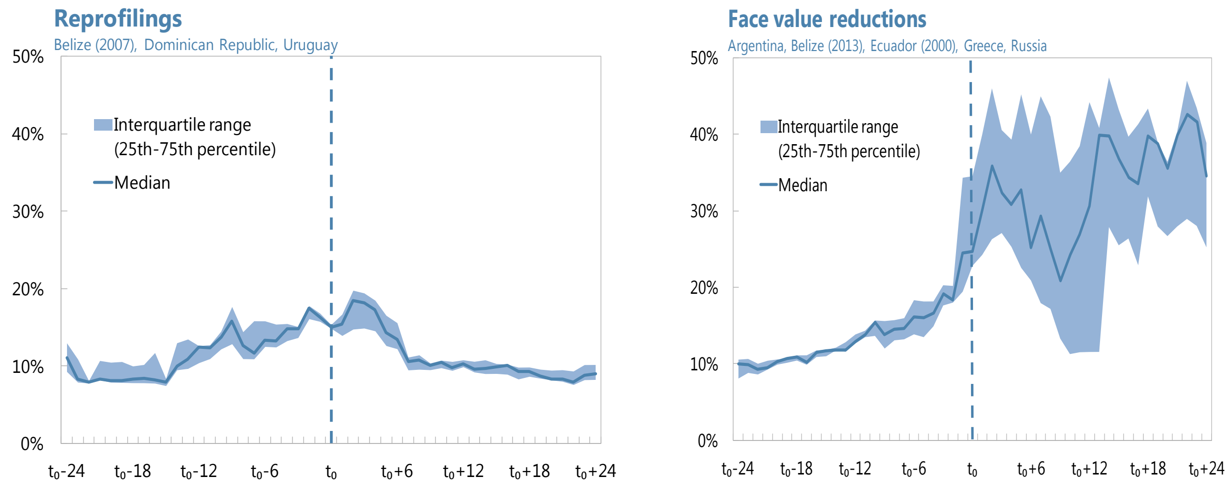
- *Reprofiling as an alternative to allowing creditors with maturing claims to exit where debt reduction proves to be necessary*. In this scenario, the member will benefit insofar as resources that would otherwise have been paid out to creditors will have been retained, and could reduce the member's overall financing needs. Alternatively, these resources could be efficiently employed to allow for a less constraining adjustment path under the Fund-supported program, thereby enhancing prospects for growth. Moreover, if and when the debt reduction occurs, any haircut needed will have been reduced, given the larger creditor base. This would be of benefit both to the longer-term creditors (who would have otherwise had to shoulder the full burden of the debt reduction) and possibly also to the member, since it increases the chances of a more rapid return to the market, as the debt stock will be less burdened by senior claims from official

[5]For the purpose of making these comparisons, the sample was divided between generally moderate face-value preserving maturity extensions and all other restructurings, with the former being a proxy for "reprofilings." This dichotomy is artificial, in the sense that debt restructurings in fact lie on a continuum in terms of their impact on NPV, and even face-value preserving operations—if they entail a very long maturity extension—could imply a significant NPV reduction. In the samples used, however, almost all the face-value preserving cases involved a smaller NPV reduction than those cases where reductions in principal were applied.

creditors. From the Fund's perspective as a financial institution, the benefits of reprofiling relative to the financing of creditor exit are two-fold. First, the amount of financing required from the Fund during the program may be significantly reduced. Second, when the debt reduction operation takes place, the member will be in a stronger position to regain financial stability and external viability and thereby repay the Fund because of the larger stock of private claims that can be restructured. Finally, from the perspective of the international monetary system, by helping to mitigate moral hazard problems associated with bailouts, reprofiling may also reduce the incidence of future crises.

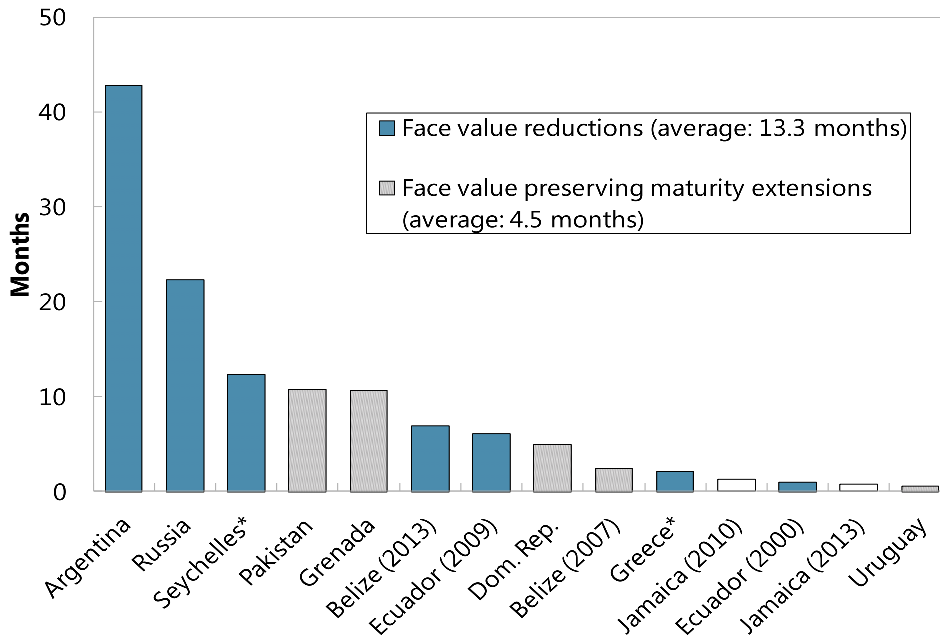
- *Reprofiling as an alternative to allowing maturing creditors to exit in cases when debt reduction is not needed, but uncertainty does not allow this assessment to be made ex ante.* In this situation, a reprofiling will involve costs that would otherwise be avoided by a bail-out, including the triggering of a credit event and a rating downgrade. Since allowing payment of maturing obligations would have been the correct approach ex post, the benefits of reprofiling depend on the market dynamics that it generates. If the reprofiling and the associated (less constraining) adjustment path allows the member to effectively address the underlying problems that led to the loss of market access, investors are likely to react positively, improving prospects for market reaccess. In contrast, if the Fund's assessment on the prospects under reprofiling is not shared by markets, investors could take the decision to reprofile as a signal of worse economic performance than they assessed and sell debt to other investors, potentially leading to higher spreads. However, this risk is mitigated by the fact that reprofiling would only be used when a member has lost market access and, accordingly, the market has already made a negative assessment of the member's situation. As is the case in all Fund-supported programs, subsequent market dynamics would depend on performance under the program as well as external developments.

Figure 1. Median Bond Yields Before and After Restructuring Announcement



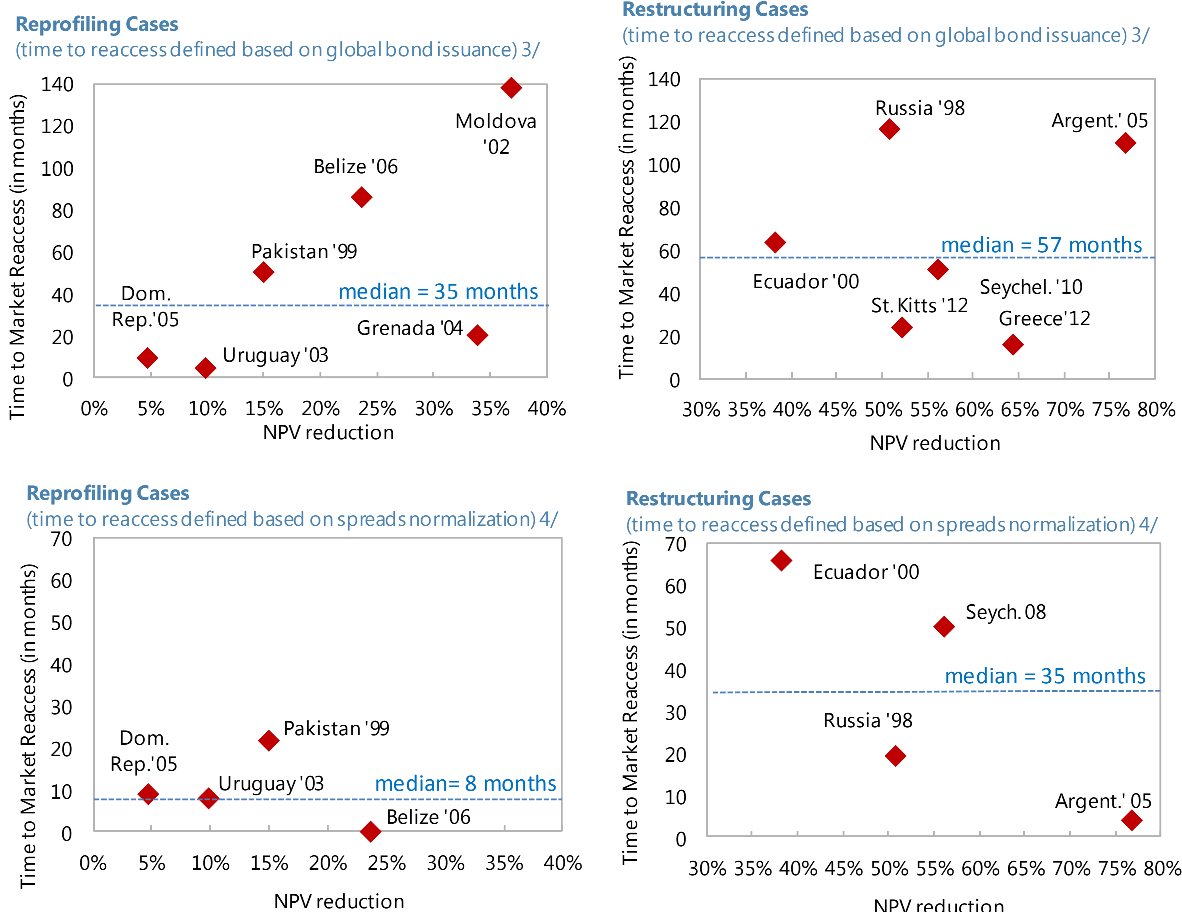
Sources: Datastream; Fund staff calculations.
Note: Sovereign spreads have risen less, and returned to precrisis levels faster, in past maturity extensions compared to debt reductions in this sample of sovereign credit events.

Figure 2. Length of S&P Selective Default Rating



Sources: S & P; and Fund staff calculations.
*SD rating for Seychelles was not followed by a non-SD rating, as S&P terminated its ratings for Seychelles on 8/16/2009. Greece was also rated SD between 12/5/2012 and 12/17/2012 but this is omitted.
Note: Jamaica, Cyprus and Ukraine are special cases of maturity extensions. In Jamaica and Cyprus, the debt operations only involved domestic bonds. In Ukraine, the operation involved a very small cut in the face value (less than 1 percent).
A selective default rating has been short-lived in past maturity extensions corresponding to the duration of the exchange offer.

Figure 3. Reprofiling and Face Value Reduction: Time to Market Reaccess 1/ 2/



Sources: Moody's Sovereign Default Series, October 7, 2013; Bloomberg; and Fund staff calculations.

1/ NPV calculations come from Cruces and Trebesch (2013) with the exception of St. Kitts where we used Sturzenegger and Zettelmeyer (2006, 2008). Cruces and Trebesch (2013) compute the NPV reduction based on the NPV of aggregate cash flows of old instruments and of new instruments. Sturzenegger and Zettelmeyer (2006, 2008) compute the weighted average of NPV reduction for each instrument based on outstanding instruments (computed using the exit yield of the new instrument).

2/ The analysis excludes cases of Belize (2013) and Cyprus (2013) as it is not clear when these countries will reaccess the markets. For countries that have not yet regained market access (as defined below), the duration of market access loss is based on April 2014 cut-off date.

3/ Time to reaccess based on global bond issuance after completion of the last debt exchange.

4/ Time to reaccess based on spreads normalization following the last debt exchange. Normalization is defined as the time it took for spreads to drop to the 12-month average prior to the distress event (announcement of default, restructuring, Fund program, financial crisis or suspension of debt payments).

Note: Reprofilings are proxied by cases involving moderate (face-value preserving) maturity extensions and NPV reductions. In the case of Argentina, the default occurred in January 2002, while the debt exchange took place in June 2005. In this regard, time to market reaccess based on spreads normalization may not represent the actual impact of the credit event.

17. Importantly, a key objective of reprofiling is to reduce the likelihood that a further debt restructuring is needed. Whether a Fund-supported program is accompanied by creditor exit or by a reprofiling, the objective during a period of uncertainty will be for the member to implement adjustment policies with sufficient credibility that, together with Fund financial support, market access is regained and debt sustainability is achieved. However, relative to a program that allows for the repayment of maturing obligations, a program accompanied by a reprofiling is likely to have a greater chance of success, by facilitating a less constraining and more politically palatable adjustment path (see Section III.C) or by improving the debt profile and hence hastening a return to market access. An analysis of past restructurings shows that when initial debt levels are moderate a light restructuring has good prospects for effectively addressing the debt problem (see Annex II). Moreover, the fact that creditors are contributing to the resolution of the crisis through a reprofiling may help the member catalyze domestic support for the implementation of the program.

18. The Fund has successfully supported reprofiling outside of the 2002 exceptional access framework, where the lending framework provides greater flexibility. In a number of Fund-supported programs within normal access limits, reprofilings were pursued as a means of addressing concerns regarding debt sustainability even though they did not resolve sustainability concerns with a high probability (see Box 4). Because the high probability threshold did not apply, the Fund was able to support these operations under its general lending framework on the grounds that they did, on balance, provide a reasonable basis to conclude that debt sustainability would be re-established. Moreover, immediately prior to the establishment of the 2002 framework, the Fund supported reprofiling in the context of a program for Uruguay that involved exceptional access—but under the more flexible "exceptional circumstances" framework described above. Although the reprofiling, when coupled with the implementation of a strong adjustment program, improved the debt outlook in Uruguay, the staff's assessment at the time was that it did not dispel concerns regarding sustainability. Thus, the "high probability" requirement would not have been met if the reprofiling had been initiated under the 2002 framework, and an operation that turned out to be successful (sustainability was ultimately restored without the need for a further debt restructuring) would have been precluded.

19. Fund support for maturity extensions was even more common during the debt crisis of the 1980s.[6] During the initial phase of the crisis, the debt problems of a number of Latin American countries were addressed through a combination of several rounds of rescheduling and new money from commercial banks—both of which were made contingent on the adoption of Fund-supported programs. During this period, the contribution made by the private sector implied the debtor countries had little need for additional financing, and thus allowed the level of Fund financing to remain relatively modest. After a period of time, it became clear that, even with the adoption of strong adjustment measures, debt reduction was needed. This culminated in the debt

[6] See Annex I.

and debt service reduction operation of the Brady Plan, which was also supported by financing from the Fund. Importantly, the earlier period of reschedulings allowed creditor banks to build provisions so that when the eventual debt reduction took place, its costs to financial stability were limited. The evolution of capital markets and, in particular the existence of a myriad of bondholders, will require a different approach when designing and implementing a reprofiling strategy.

20. One risk associated with the additional flexibility (relative to the 2002 Framework) is that it could be used to delay debt reduction that is already, at the outset, considered necessary. As discussed, the reprofiling option would be designed to be used only where there is considerable uncertainty as to whether the member's debt is sustainable or unsustainable. Where it is clear that the member's debt is unsustainable, reprofiling would not be sufficient and some form of debt reduction operation would be necessary. However, as described in the 2013 paper, experience demonstrates that there is an alignment of incentives among sovereign debtors, private creditors and members of the official sector to delay debt reduction even where it has become relatively clear that it is needed.[7] Given the observation that reprofiling is likely to be less disruptive—both for the member and the system—it is possible that this option could be relied upon even in those circumstances: i.e., that it might actually exacerbate the delay in a needed debt reduction. While one cannot rule out that risk, it needs to be weighed against the alternative risk; namely that, given these incentives, the Fund deploys the catalytic approach, and debt reduction is delayed while creditors with maturing claims exit. Nevertheless, to address this concern, the Fund would normally not support successive reprofilings, for both exceptional and normal access programs. This would help ensure that if a reprofiling is not successful, it would be followed by a debt reduction to help the member avoid the economic and welfare costs associated with debt overhang.

21. The benefits of reprofiling have also been explored in other fora. For example, proposals have been advanced to introduce contractual provisions in sovereign bonds that would automatically trigger maturity extensions when specified objective conditions are met, including a member's request for financial assistance from the Fund (e.g., Brooke and others (2013)). While such an approach has the benefit of providing predictability to the market, it would not allow for a case-by-case assessment of the member's debt situation—a feature that is central to the approach taken by this paper.

D. Addressing contagion concerns

22. In circumstances where a judgment is reached that debt sustainability is uncertain and, accordingly, a reprofiling should take place, there should not be a "systemic contagion exemption" to such a reprofiling. As noted above, the existing systemic exemption not only raises equity concerns but also revives the underlying concerns regarding moral hazard and Fund

[7] See Annex II for a review of sovereign debt restructurings since the 1980s.

safeguards that gave rise to the 2002 framework. If such an exemption were maintained, these problems would persist—in effect, it would risk becoming an increasingly significant loophole. At the same time, it is recognized that, when reprofiling is used, the accompanying program would need to be designed to minimize the costs on the financial system and spillovers.

23. Beyond these broad considerations, there are several reasons why such an exemption would be neither necessary nor desirable:

- First, to the extent that concerns regarding contagion arise from the balance sheet effects on creditors located outside the member, these risks will be reduced with a reprofiling since, relative to a debt reduction, the NPV impact will be more limited (see Box 5 and Annex III). The case for resorting to a bail-out because of contagion concerns will be correspondingly weaker when the alternative is reprofiling rather than debt reduction.

- Second, even though a reprofiling—by triggering a credit event—may have cross-border contagion effects, these consequences need to be assessed against the alternative options. Evidence suggests that, in sovereign debt markets, cross-border contagion effects spike during periods of policy uncertainty (see Annex III). The key to address contagion is to have a credible solution to sovereign distress; without such a solution, even bail-outs will in the end fail to avert contagion if they leave a debt problem unresolved. Conversely, as long as a reprofiling decision is taken promptly and provides an adequate basis to conclude that the member's debt problems are being addressed while appropriate firewalls are being built to protect the financial system, experience suggests that any contagion will abate (see Box 5).

- Third, it is acknowledged that contagion may be attributable to broader concerns regarding changes in the "rules of the game." In particular, a decision to restructure one member's debt may be viewed as a signal that a new approach is being taken that will be replicated with respect to other members where debt sustainability concerns exist. It might also indicate that the Fund has concerns regarding the economic or debt sustainability prospects of other members that markets had not hitherto perceived. Such contagion could possibly occur in highly integrated currency unions or possibly across large emerging markets which are viewed by investors as a single asset class when the debt of one large emerging market is reprofiled. Such cross-border effects could lead investors to pull out of countries whose debt sustainability prospects are uncertain. To the extent that there are grounds for uncertainty regarding debt sustainability in other members, however, it would be both inappropriate and counterproductive for the Fund to create an exemption that defers the recognition that debt sustainability problems need to be addressed. Conversely, in those members where debt sustainability is not in doubt, the appropriate solution is the implementation of strong adjustment measures and significant financial support—not the deferral of a restructuring that is needed elsewhere. Invoking a systemic exemption in such cases would promote moral hazard in the system.

24. It is recognized that there may nevertheless still be circumstances where potential contagion risks require a special response:

- First, in the specific circumstances of a currency union with highly interconnected financial markets, limiting contagion to other members would need to rely on system-wide backstops, with prompt action taken to strengthen such backstops if necessary.[8] The experience with Fund-supported programs in the euro area showed that the decisive factor in stemming market distress and spillover effects was the action taken to put in place credible firewalls, including the commitment by the central bank to ensure zone-wide stability through the necessary support measures.

- Second, one cannot rule out the possibility that, in the case of a member of sufficient systemic importance, any debt restructuring—whether a reprofiling or a debt reduction—may risk triggering a systemic crisis, given the impact that such a restructuring might have on the financial systems of other members. In a situation of this kind, the Fund membership may conclude that it could be less costly to the overall stability of the financial system to delay a decision on debt restructuring, irrespective of whether debt is sustainable—at any level of probability.

25. A key challenge in addressing the second situation described above relates to the Fund's own mandate. The Fund is legally precluded from providing financing to address systemic risk without regard to the member's debt sustainability. While a systemic exemption can lower the minimum probability threshold relating to sustainability, it cannot dispense with this requirement. In those rare cases where any form of debt restructuring could have a major systemic impact, it is very likely that there will be pressure to delay—irrespective of debt sustainability at any level of probability.

26. Taking into account the above limitations, several alternative approaches could be considered:

- First, where contagion concerns are acute, the problem of sustainability could be addressed by the receipt of assurances of concessional support from other official creditors. Provided that these assurances are sufficiently specific to be credible, the Fund could proceed without a restructuring of private sector claims, since an alternative means to achieving sustainability would have been secured. One of the drawbacks of this solution is that, while it addresses the problem of sustainability, the use of official sector financing to bail out the private sector will

[8]Adequate domestic backstops (e.g., bank recapitalization funds) would also have to be in place together with the appropriate bank resolution toolkit.

exacerbate the moral hazard problem that the possible reform considered in this paper is trying to address. However, in those rare circumstances where any form of debt restructuring would have major systemic implications, the membership may conclude that official sector financing may be preferable. The burden in such circumstances should not fall wholly on the member for whom the program is being granted, given the public good aspect of the decision, but should be shared more widely.

- Second, where official creditors are unwilling to provide financing on a concessional basis, those that are most concerned about the impact of contagion could provide financing on their own. Since the Fund would not be involved, the financing would not need to be provided on concessional terms given that no judgment on sustainability is being made. Like the first approach, this one has the drawback of both engendering moral hazard and delaying a restructuring that has become inevitable. Moreover, members may be reluctant to provide official financing without a Fund-supported program, as limiting contagion is likely to also require credible measures from the contagion-emitting country. This problem could potentially be mitigated through the provision of technical assistance by the Fund on the adjustment policies that are needed.

27. As a legal matter, it is recognized that the Executive Board could, by a majority of votes cast, amend a modified exceptional access framework to create a new systemic exemption, as was done in 2010. However, as a policy matter, such an exemption would not be an effective means of addressing contagion, as discussed above. Moreover, such a modification could only allow for Fund lending where there is uncertainty—as discussed above, the Fund is precluded from providing financing without a restructuring where it is relatively clear that the member's debt is unsustainable.

E. Potential *ex ante* effects

28. The ex ante effects of the possible reform on countries' "steady state" borrowing costs are likely to be limited. The Fund has engaged in informal outreach with a range of market participants regarding the potential direction of reform. There was a general view that, since the considered approach would continue to rely on the exercise of discretion, its impact will largely depend on how it is applied in practice. In any event, there was a broadly held view that, since "steady state" borrowing costs are driven primarily by the perceived creditworthiness of a particular sovereign rather than the specific design features of the Fund's lending framework, such reforms were unlikely to have an impact on borrowing costs.[9]

[9] Staff also examined if the introduction of the original exceptional access framework in 2002 had an impact on countries' borrowing costs. As shown in Box AIII1 of Annex III, the overall effects were negligible or beneficial for countries with stronger fundamentals.

29. In contrast, it is possible that the reforms considered in this paper may have an impact on market dynamics for a country entering distress. It is very likely that the market perceives the systemic exemption as being one that will be generously applied. Accordingly, its elimination could result in creditors demanding demand higher rates when a sovereign enters a period of distress, since they may predict that, relative to the status quo, there is a greater possibility of some form of debt restructuring. Since a reprofiling is more likely to affect short term claims, this may have a particular impact on the rates charged on short-term debt. However, this can viewed as a healthy development in so far as it results in a better pricing of risk. As debt vulnerabilities emerge, more cautious lending behavior would tend to mean that corrective measures have to be taken sooner, reducing costs for all involved. It would also give appropriate incentives to policy makers in countries with weak fundamentals to avoid allowing their debt problems to fester and to take earlier action to undertake needed reforms, thereby reducing the likelihood that a restructuring would actually be needed.

III. DESIGN AND IMPLEMENTATION ISSUES

30. This section addresses with greater specificity a number of issues that would need to be addressed when designing and implementing the type of amendments to the exceptional access framework described in Section II. As discussed, an amended exceptional access policy would continue to involve a case-by-case assessment of the circumstances of the member in light of the general criteria set forth in the policy. There would be no automaticity. Unlike the framework established in 2002, however, the Executive Board would not be required, in circumstances of uncertainty, to make Fund financing conditional upon debt restructuring sufficient to establish sustainability with a high probability. But unlike the modification introduced in 2010—which introduced the systemic exemption—the Fund would have a framework that effectively addresses the underlying concerns that motivated the establishment of the 2002 framework.

A. When should a reprofiling take place?

31. The circumstances when a reprofiling would be appropriate would be circumscribed. Specifically, and as indicated in the first section, where the Fund has confidence (i.e., with "high probability") that the debt is sustainable, it would be appropriate for the Fund to rely on its traditional catalytic role so as to enable the member to continue to service its original claims. Conversely, where the Fund has confidence (again, with "high probability") that the debt is *un*sustainable, exceptional access would only be granted on the condition that a member seeks sufficiently deep debt reduction in order to establish clear sustainability. Reprofiling would only be appropriate where the Fund does not have sufficient confidence to make either of these determinations—i.e., where there is uncertainty.

32. In light of the above, a key issue will be to identify the general criteria that would guide the Fund's assessment as to when a member's situation is sufficiently uncertain that a reprofiling would be appropriate. For purposes of identifying these criteria, it will be important to ensure that the benefits of the Fund's catalytic role are not undermined. In particular, the criteria

should be designed to avoid any perception of a "presumption" that Fund financing involving exceptional access for a member with significant debt problems will always be accompanied by a reprofiling. Moreover, it will be important to avoid relying exclusively on market indicators when designing these criteria so as to avoid a self-fulfilling loss of market access.

33. In order to address these concerns, it would be reasonable to require that two conditions be met before the Fund determines that a reprofiling should take place as a condition for exceptional access. Figure 4 shows the circumstances in which a reprofiling would be appropriate.

- First, the member must have already lost market access. Clearly, if the market continues to have confidence that the member can continue to service its original obligations, the Fund should seek to bolster—not second-guess—this confidence. Conversely, a loss of market access represents an important signal that, from the perspective of investors, the member's ability to meet its obligations has become uncertain. As is currently the case, an assessment of whether a member continues to have market access would require the exercise of judgment, and would be based on a case-by-case assessment of whether the member can tap international capital on a sustained basis through the contracting of loans or issuance of securities across a range of maturities (in both local and foreign currencies) at interest rates compatible with reasonable medium term growth rates and an achievable primary fiscal position. The types of indicators that are currently used—and would continue to be used—for purposes of assessing market access are summarized in Box 6.

- Second, even if market access has been lost, reprofiling would only be appropriate where a complete DSA suggests that there is considerable uncertainty regarding the sustainability of the member's debt situation and, accordingly, considerable uncertainty as to whether the loss of market access will be temporary.[10] For purposes of making this assessment, and consistent with the current approach, there would be no predefined indicator thresholds. Rather, the Fund would assess the relevant DSA indicators to judge whether a conclusion can be reached that there is a high probability of either sustainability or unsustainability. Reprofiling would only be called for where it is not possible to reach either of these conclusions. To avoid a self-fulfilling

[10] To assess debt sustainability for the purposes of meeting the exceptional access criteria as well as for broader surveillance and analytical purposes, the Fund focuses on "public debt." As noted in the DSA staff guidance note, "coverage of public debt in the DSA should be as broad as possible, but consistent with the coverage of the fiscal accounts monitored for surveillance and program purposes, and should take into account the availability (and frequency) of fiscal data" (IMF Policy Paper, available via the internet: http://www.imf.org/external/np/pp/eng/2013/050913.pdf). In practice, a large number of countries report fiscal aggregates only at the general government level but staff is encouraged to include other units in the public sector (e.g., state-owned enterprises) if the they pose fiscal risks. Similarly, "any potential contingent liabilities of the government, including those potentially arising from very high private external indebtedness (as could be the case when the authorities assume liabilities of failed private banks that enjoyed significant foreign financing) should be incorporated into the analysis of public debt sustainability" (Available via the Internet: http://www.imf.org/external/np/pp/eng/2009/031909A.pdf).

loss of market access, market-related indicators (e.g., current sovereign spreads) would be excluded from this analysis. The DSA would be based on a program that includes those policy measures considered necessary to strengthen the financial position of the sovereign, directly or indirectly. For example, where threats to sustainability arise from an insolvent banking sector, it would be appropriate for the adjustment program to rely on a bank restructuring operation whereby bank creditors absorb the costs of this insolvency, thereby avoiding an additional burden on the sovereign balance sheet from state capital injections.

Figure 4. Assessment of Debt Sustainability, Market Access, and Fund Lending

Assessment of Debt Sustainability, Market Access, and Fund Lending

Member has market access	**Normal Fund lending**	**Normal Fund lending**	**Unlikely**
Member has lost market access	**Normal Fund lending**	**Reprofile**	**Upfront debt reduction**
	Debt sustainable with high probability (i.e. market access loss is temporary)	**Uncertain**	**Debt unsustainable with high probability**

Low — DSA Debt Burden Indicators — High

This schematic illustrates the considered framework relating options for Fund lending to assessments of debt sustainability and market access. In cases where there is a high probability that debt is sustainable, Fund lending would play its normal catalytic role. In cases where there is a high probability that debt is unsustainable, an upfront debt reduction would be required. In situations where there is uncertainty as to whether debt is sustainable or unsustainable and the member country has lost market access, Fund lending would be conditional on reprofiling.

34. As under current practice, the staff would seek guidance from the Executive Board regarding these judgments prior to initiating discussions on an exceptional access program. Directors would have an early opportunity to comment on the preliminary DSA and market access assessment, and hence on the approach the staff is considering to take with regard to the member's debt. This procedural requirement in exceptional cases—which would continue to apply—should help ensure that all relevant country-specific considerations are taken into account in applying the Fund's DSA framework and making an ultimate judgment on what action (if any) is called for on debt.

35. While an assessment may be made that a reprofiling is needed when the member approaches the Fund for financial support, it could also be made in the context of an existing Fund-supported program. In circumstances where a member's debt outlook becomes considerably more uncertain during an existing exceptional access arrangement, continued Fund support would be made conditional upon the implementation of a reprofiling. Indeed, the

possibility that a reprofiling may be needed if the program is not successfully implemented is likely to provide additional incentives for the member to effectively implement the program.

B. The length of the reprofiling period and the scope of debt to be covered

36. When considering the appropriate length of the reprofiling, it is helpful to recall the objectives identified in the previous section. On the one hand, any reprofiling should be long enough to allow the adjustment policies to be implemented and take hold, thereby reducing the uncertainty that gave rise to the need for the reprofiling in the first place. As will be discussed further below, the financing delivered by the reprofiling may allow for the design of a program that is likely to increase the chances that this will occur. On the other hand, given that one of the objectives of a reprofiling is to avoid the costs that are inherent in a debt reduction operation, it is important that it not be so long that it results in a significant reduction in the net present value of the claims of creditors, which will only serve to delay a return to market access. Moreover, if the reprofiling period is too long, it may delay much needed deeper debt reduction—a delay that also creates costs insofar as the debt overhang impedes economic recovery. In light of these considerations, a reprofiling would be designed to allow the member to defer servicing of principal (interest would continue to be paid) for a period that would normally not exceed three years (the "reprofiling" period). The precise length of this period could vary, however, depending on the specifics of the Fund-supported program and the maturity structure of the claims on the member.

37. In terms of the scope of debt to be reprofiled, while there would be sufficient flexibility to take into account the circumstances of each member, consideration would need to be given to several objectives. First, at a minimum, the scope of debt covered should give the authorities sufficient breathing room to allow the adjustment policies to take hold. Second, in order for creditors to be willing to participate in the reprofiling, they will need to be persuaded that inter-creditor equity considerations have been addressed. For both these reasons, it will likely be necessary that similar claims held by both residents and nonresidents will need to be covered. Third, financial stability considerations will need to be taken into account, while ensuring that the desired improvement in prospects for debt sustainability is not unduly compromised. For instance, it may be necessary to exclude treasury bills to preserve the functioning of financial markets. Financial stability concerns could also be addressed through appropriate measures in the program, as has been the case in other reprofilings (see Annex IV). Whether or not claims falling due outside the reprofiling period are also extended will depend on the circumstances of the member. For example, even if it is not required for purposes of the program, these claims may need to be covered for inter-creditor equity reasons, or to avoid a "wall" of maturities immediately after the reprofiling period. However, and as is the case with all debt restructuring operations, the Fund would not seek to micromanage the process. As long as the reprofiling had sufficient creditor participation to deliver the financing needed during the relevant period, while preserving financial stability, it would be for the authorities and their advisors to design the specifics of the operation. Finally, while the assessment of debt sustainability will cover the public sector broadly defined (as noted above), the scope of reprofiling would be limited to sovereign debt—that is, debt contracted

or guaranteed by the general government. This approach is motivated by the fact that any restructuring of the member's non-sovereign debt will be achieved through the domestic legal framework of the member.

38. A reprofiling would also be expected to maintain the exposure of official bilateral creditors. The Fund has ample experience in this regard with the Paris Club, where bilateral official creditors reschedule or reduce their claims on terms consistent with the financing assumptions in a Fund-supported program. For non-Paris Club official creditors, or for debt restructurings conducted outside the Paris Club framework, the Fund would need adequate financing assurances providing sufficient clarity on the magnitude, timing and modalities of debt relief. The net exposure of an official creditor could also be maintained by the provision of new financing. For official creditors, the provision of new money or debt relief in the form of rescheduling will be easier in circumstances where the private sector is also participating in the financing. Conversely, private sector creditors are more likely to agree to a reprofiling if they understand that there is adequate burden sharing between the private sector and official bilateral creditors.

39. There may be circumstances where it would not be cost-effective for the member to reprofile debt held by private creditors. In particular, this may arise when the vast bulk of debt service falling due during the program period is held by official creditors, and scheduled payments to private creditors are sufficiently small that the costs of reprofiling them would outweigh the benefits for the member's program. In such situations, adequate financial commitments by official creditors should be sufficient to warrant Fund support, without the need for private sector participation.

40. What would happen if the uncertainty regarding the member's debt sustainability persists? While there would be no automatic "conversion" to a debt reduction operation, the expectation would be that, if and when it becomes clear that the debt outlook is not improving as envisaged, deeper debt reduction would indeed be needed—for at least two reasons. First, the failure of the program to effectively address the debt dynamics of the member would strongly suggest that the underlying debt problems were even more severe than originally thought. Second, having asked creditors to reprofile their claims once, it would be inappropriate to ask them to do so again. At that point, it would be more appropriate—from the perspective of both the member and its creditors—to initiate a debt restructuring operation that deals with the underlying debt problems in a more definitive way.

C. The design of the Fund-supported program

41. As noted earlier, one of the advantages of a reprofiling is that, relative to a program that allows for the repayment of maturing obligations, it will enable the Fund to support a less constraining adjustment path that, accordingly, has a greater chance of securing debt sustainability. Even in exceptional access cases, there are constraints on the scale of financing that the Fund and other official creditors are able or willing to provide. This may dictate an adjustment path that is more front-loaded than would be desirable from a growth perspective. Highly pro-cyclical adjustment policies can be damaging to medium-term debt sustainability in at least two

ways. First, there is strong evidence that sharp recessions lead to permanent output losses, through hysteresis effects. Lower steady-state output would aggravate the debt burden, other things equal. Second, from the outset, severe policy adjustment measures and the resulting downturn in growth and employment may strain the political capacity of a government to sustain the adjustment effort, leading in extremis to program failure and hence jeopardizing debt sustainability. Reprofiling could help mitigate these risks. At least a portion of the resources conserved through reprofiling could be used to finance a more evenly-phased adjustment path toward the given steady-state objective—making the program less procyclical, limiting hysteresis effects, and rendering the adjustment effort more viable from a political economy perspective. (Annex V illustrates these points using stylized model-based simulations.) By easing the balance of payments constraint, it could also avert an unduly sharp exchange rate depreciation, which could aggravate debt burdens in both the public and private sectors. Since some additional debt would be incurred in the process, however, this option may not be advisable for the most heavily-indebted members. In such cases, the resources conserved through reprofiling would be better used to reduce the overall scale of program financing.

42. Any reprofiling operation should be designed in a manner that does not delay Fund support. Experience demonstrates that a debt restructuring operation can be completed relatively quickly, sometimes within 90 days. In many cases, the nature and timing of financing needs may be such that a reprofiling can be concluded before the approval of the Fund-supported program. If, however, urgent assistance is needed to enable the member to continue meeting its payment obligations prior to completion of a reprofiling, the policy would retain flexibility for the Fund to provide financial support to cover the member's financing needs in the interim. To achieve this, the Fund would follow an approach that is similar to the one it currently relies on where deeper debt reduction operations are considered necessary to ensure debt sustainability; namely, the arrangement would be approved—and the first purchase made available—based on a credible commitment that reprofiling will be carried out by the time of a specified review. The parameters of the program would define the amount of financing that the reprofiling would be expected to deliver and, accordingly, would provide the anchor for consultations between the sovereign and its creditors.

D. Securing creditor support

43. It is critical that any reprofiling be implemented in a manner that garners broad creditor support. This will be essential not only for purposes of securing high creditor participation in a particular reprofiling operation, but also for purposes of maintaining sovereign debt as a valuable asset class for investors. For example, it will be important that the reprofiling be implemented in a manner that, to the extent possible, avoids a payment default. That is, the agreement among creditors to extend the maturities of their claims should take place while the debtor country continues to service these claims. A payment default could exacerbate financial instability and make it more difficult for the sovereign to regain market access. As noted above, in circumstances where an arrangement has been approved prior to the completion of a reprofiling operation, the Fund would normally indicate that a subsequent review would not be completed

until the reprofiling operation has been successfully concluded (as was done in the case of Uruguay).

44. Even in the absence of a payment default, it is recognized that a reprofiling will most likely trigger a credit event under ISDA contracts, due to the likely activation of collective action clauses (see discussion below). Moreover, based on existing practice, it is also likely to result in the member receiving a credit downgrade among credit rating agencies. However, since these events would occur only after the member would have lost market access, the disruptive effect on the member would be limited. Indeed, it is very likely that, if the reprofiling is successful and the member has demonstrated a commitment to implement the program, the capacity of the debtor to service its claims will have improved, and the rating will emerge soon from Selective Default, as has been the case in previous reprofiling operations. The evidence suggests that if a debt restructuring effectively addresses underlying uncertainties regarding a sovereign's capacity to repay, sovereign prices are likely to adjust to this more optimistic scenario.

45. Since most sovereign debt is in the form of bonds, the reprofiling would largely be effected by bondholders agreeing to an extension of the maturity of their bonds, which would most likely be achieved through a bond exchange. In order to deliver the needed financing—and to avoid a payment default—it will be imperative for the participation rate in the exchange to be as high as possible. As in the case of debt reduction operations, most creditors will only participate if they perceive that participation is preferable to the alternative. In that regard, creditors will need to be persuaded that (i) there is a serious risk that the distress being experienced by the member is such that the member will not be able to service its claims, leading to a payment default and some form of debt reduction operation and (ii) a reprofiling, when coupled with the adjustment policies that are being supported by the Fund, will significantly increase the chances that such a payment default and debt reduction operation can be avoided. Because of (i), it is important that the reprofiling option only be utilized after the market has already reached its own judgment on the risks faced by the member (i.e., after a loss of market access). Because of (ii), it is imperative that the program provide a viable path to sustainability. If creditors perceive that the reprofiling is simply the opening stage of an inevitable debt reduction operation, they will understandably refrain from participating.

46. In light of the above, obtaining creditor support will require adequate creditor consultation by the member prior to the initiation of the exchange. As part of that outreach, Fund staff will be ready to explain both the need for the reprofiling and the reasons why the Fund-supported program, if implemented, stands the best chance of avoiding a debt reduction. In light of experience, the form of the consultation with creditors will necessarily vary, depending on the circumstances of the case. It will be important that Fund staff, at the request of the member, be able to explain the analysis and judgments that underpin the conclusions of the DSA so that creditors are in a position to make informed decisions.

47. Provided that the exchange delivers the needed financing relief during the reprofiling period, the Fund would not micromanage the process or be prescriptive in terms of the instruments offered. As noted above, the authorities and their advisors would determine whether,

for inter-creditor equity or other purposes (e.g., bunching of maturities), it is necessary to reprofile any claims that fall due outside the reprofiling period. Similarly, a determination would need to be made as to whether claims falling due within the reprofiling period would need to be extended by the same amount. From a financing perspective, for example, a claim falling due at the end of the reprofiling period may not need to be extended as much as a claim falling due at the beginning of the period. How these issues are resolved will depend, in part, on the design of the collective action clauses, which are discussed below.

48. Further consideration could be given as to whether the Fund should play a more active role in providing additional incentives for creditors to participate in a reprofiling. While the risk of default arising from the Fund's readiness to withhold financial support in the absence of a reprofiling may be sufficient to catalyze high participation, it may be beneficial for the Fund to apply a limited amount of its resources to make the reprofiling more attractive to creditors, drawing on the techniques that were utilized during the 1980s debt crisis. As described in Annex I, the Fund adopted a specific policy in the late 1980s designed to support the conversion of outstanding syndicated bank debt into Brady bonds. Under one of the operations specified in that policy, a portion of the member's access was set aside and released to the member at the conclusion of the debt operation for the specified purpose of collateralizing the interest payments to be made on the newly issued bonds during the program period. Consideration could be given to implementing some variation of this type of operation (e.g., collateralization of a portion of the interest payments on the reprofiled instruments), which may have a beneficial impact on the trading value of the reprofiled bonds and thereby reduce investor losses and facilitate earlier market reaccess. The costs and benefits of such enhancements will be discussed in a follow-up paper.

49. During the informal consultation process, some market participants conveyed their strong desire for a more meaningful creditor engagement process. In particular, they emphasized the need for a greater reliance on the use of creditor committees. The Fund recognizes that, in order to achieve a high participation rate—which is critical for the success of the reprofiling and the program—a debtor would be wise to engage with a creditor committee when the composition of the committee is sufficiently broad to enable it to effectively represent the creditor body. However, it also needs to be recognized that there have been a number of cases where high participation has been reached without the reliance on creditor committees. The modalities of creditor engagement in pre- and post-default cases will be discussed in greater detail in a subsequent staff paper.

E. Resolving collective action problems

50. Even if most creditors have reached the conclusion that a reprofiling is in their collective self-interest, they may be reluctant to support a reprofiling out of a concern regarding free rider problems. Specifically, there may be concerns that, after the reprofiling, a minority of creditors who have declined to participate in the exchange are either paid under the original terms or, if there has been a default, sue for full payment. During the 1980s, collective action problems were kept to a minimum as result of the composition of creditors: negotiations took place among a limited number of banks, all of whom were subject to regulatory suasion by the

official sector. With the evolution of sovereign debt markets, however, credit is typically extended—or purchased on the secondary market—by a large group of bondholders who have diverse interests, some of whom specialize in purchasing the claims at a steep discount and pressing for full payment after the restructuring has taken place.

51. Notwithstanding this problem, techniques have been developed over the years to address these collective action problems.

- First, in the context of a debt exchange, a sovereign can impose a minimum participation threshold; i.e., creditors are informed in the relevant documentation that the restructuring will only take place if a minimum percentage of creditors accept the restructuring offer. This participation threshold can be as high as 90 percent.

- Second, most—but not all—bond contracts governed by foreign law now include "collective action clauses" which enable a qualified majority of creditors of a particular bond issuance to bind a minority of creditors of the same issuance to the terms of the restructuring. Inclusion of collective action clauses has become the market practice for bonds governed by English and New York law, although there continues to be an outstanding stock of foreign law bonds without such clauses. Out of the approximately US$1.2 trillion foreign law bonds outstanding, about 25 percent do not include collective action clauses. More specifically, of a total outstanding stock of New York law bonds of about US$500 billion (about 40 percent of all issuances), about 20 percent or US$100 billion do not include collective action clauses. While collective action clauses are not a common feature of existing bonds governed by domestic law, these bonds can be restructured given the power of the sovereign to change its own domestic law.

- Third, exit consents have been used to encourage participation of creditors and reduce incentive of holdouts. This technique allows a majority of creditors to change certain nonpayment terms contained in their existing bonds (such as financial covenants) when accepting the exchange offer as a means of encouraging prospective holdouts to participate in the exchange. They have been successfully used in Uruguay and other cases where collective action clauses are not available to achieve high participation rates in bond exchanges.

52. One of the important limitations with collective action clauses and exit consents is that they typically only bind holders of the same issuance. Accordingly, it is possible for a holdout creditor to neutralize the operation of such clauses by obtain a blocking position (normally over 25 percent) of an issuance. The risk posed by this limitation has increased as a result of the litigation involving Argentina. In essence, the U.S. courts have interpreted a "boiler plate provision" of these contracts (the pari passu clause) as requiring a sovereign debtor to make full payment on a defaulted claim (in this case, held by the secondary market purchaser) if it makes any payments on the restructured bonds. As discussed in the 2013 Board paper, the Argentine decisions, if upheld, would likely give holdout creditors greater leverage and make the debt restructuring process more complicated for two reasons. First, by allowing holdouts to interrupt the flow of payments to creditors who have participated in the restructuring, the decisions would likely discourage creditors

from participating in a voluntary restructuring. Second, by offering holdouts a mechanism to extract recovery outside a voluntary debt exchange, the decisions would increase the risk that holdouts will multiply and creditors who are otherwise inclined to agree to a restructuring may be less likely to do so due to inter-creditor equity concerns.

53. On the assumption that the above U.S. court decisions remain final (they are currently on appeal to the U.S. Supreme Court), discussions have been underway to modify sovereign bond contracts in a manner that would limit the impact of these decisions. In this regard, there is a growing consensus that the pari passu provision should be amended to preclude the type of interpretation that was reached by the U.S. Courts. There are also ongoing discussions on the feasibility and desirability of designing clauses that would include a form of "aggregation" clause that is more robust from a collective action perspective than those currently in existence. The recognition of the benefits of aggregation pre-dates the Argentine litigation. These developments will be discussed in an Executive Board paper to be issued shortly. However, even if these amended provisions are introduced into new bonds, it would take approximately 10 years for this stock to be replaced. Accordingly, it would not be appropriate to make the outcome of the discussions regarding a modification of the Fund's lending framework contingent on progress on revisions to the contractual framework. It should be emphasized that the above issues arise in the context of all types of restructuring, and are not limited to reprofiling operations. If the above-referenced court decisions are final, a broader review of the implications of these decisions on the restructuring process in the near to medium term (i.e., during the period before the outstanding stock has been replaced by the revised contractual provisions) will be needed.

F. Implications for the normal access framework

54. Although many of the benefits from reprofiling may apply equally in normal access cases when debt sustainability is in doubt, staff does not suggest making it a requirement in such situations. For programs within normal access limits, current policy does not require debt restructuring except in situations where debt is assessed to be unsustainable. In such cases, action must be taken to restore sustainability. Accordingly, in circumstances where there is uncertainty on the question of sustainability, the policy gives the Fund the option of either relying on the catalytic approach or requiring some form of debt operation—a reprofiling or a debt reduction. This latitude reflects the lower financial risks to the Fund when access is within normal limits and it is recommended that this approach continue. There is a risk that this latitude available to the Fund in the normal access context could be used to pay out private creditors with Fund resources in circumstances where the prospects for debt sustainability are uncertain. However, making reprofiling a requirement for normal access programs when debt sustainability is uncertain would be more difficult to justify in light of the lower financial risk for the Fund. Indeed, such an approach would effectively apply the same debt sustainability standard to normal access programs as the staff is proposing to apply for exceptional access cases, whereas the Board has established that it expects to see stronger safeguards for exceptional access, in recognition of the greater risks involved for the Fund.

55. Staff would, however, suggest that a policy be established to limit repeated use of reprofilings in normal access cases, in line with what is considered under exceptional access. The concern to be addressed here is that Fund-supported programs—regardless of the access level—should not support debt reprofiling when a more definitive solution to the member's debt problem is called for. A need for repeat reprofilings (within some defined period) would provide a clear signal that debt is not sustainable, and deferring the problem would impede program success. It is therefore being considered that, if a reprofiling—together with the program—is not sufficient to restore debt sustainability and market access, continued Fund support under normal access should be conditioned on a definitive debt operation.

G. Clarifying the market access criterion

56. It is proposed that follow-up staff work clarify the third exceptional access criterion on market access. This criterion requires that the "member has prospects of gaining or regaining access to private capital markets within the timeframe when Fund resources are outstanding." The underlying assumption is that the member would need to regain access to capital markets in order to achieve medium term sustainability (thereby resolving its balance of payments problems) and for the Fund to be repaid. As noted in the 2013 paper, the Fund's experience in recent euro area programs has raised the question as to how this criterion should be evaluated when official lenders make open-ended commitments to support countries until they regain market access, as in the case of Greece. A related issue pertains to the time frame in which market access needs to be established so as to satisfy this criterion. These elements could usefully be clarified in follow-up staff work. They would also be relevant in cases where official creditors provide concessional support to member countries, as described in Section II.D.

IV. ISSUES FOR DISCUSSION

57. The considerations in this paper seek to provide the Fund with a broader range of potential policy responses in the context of sovereign debt distress. Compared to the status quo, these approaches would allow the Fund to better calibrate appropriate policy actions to the nature of the debt problem being faced by the members. If Directors agree with this direction of possible reform, staff will prepare a follow-up paper for the Board's consideration that will propose decisions on the necessary changes to the Fund's lending framework. At this stage, it may be helpful to exchange views on the following:

- Do Directors agree that the exceptional access framework established in 2002 poses undue constraints on the Fund's ability to respond to a member's debt problems in an appropriate and least-cost manner?

- Do Directors support the possible modifications to the exceptional access framework described in Section II.B?

- Do Directors agree that the existing systemic exemption established in 2010 should be eliminated and that, if needed in extreme cases, the alternative approaches described in Section II.D be considered to address the risk of contagion that may arise from a debt restructuring?

- Do Directors agree with the key issues on the design and implementation of reprofiling, as described in Sections III.A, B, and D? Do Directors agree that while the considered changes should not be applicable to normal access cases, a policy should be established to avoid repeat reprofilings in normal access cases?

Box 1. Exceptional Access Criteria

Four substantive criteria must be met before the Fund may approve access in excess of normal limits:

Criterion 1. The member is experiencing or has the potential to experience exceptional balance of payments pressures on the current account or the capital account, resulting in a need for Fund financing that cannot be met within the normal limits.

Criterion 2. A rigorous and systematic analysis indicates that there is a high probability that the member's public debt is sustainable in the medium term. However, in instances where there are significant uncertainties that make it difficult to state categorically that there is a high probability that the debt is sustainable over this period, exceptional access would be justified if there is a high risk of international systemic spillovers. Debt sustainability for these purposes will be evaluated on a forward-looking basis and may take into account, inter alia, the intended restructuring of debt to restore sustainability. This criterion applies only to public (domestic and external) debt. However, the analysis of such public debt sustainability will incorporate any potential contingent liabilities of the government, including those potentially arising from private external indebtedness.

Criterion 3. The member has prospects of gaining or regaining access to private capital markets within the timeframe when Fund resources are outstanding.

Criterion 4. The policy program of the member provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment.

Box 2. Relationship Between Creditor Losses and Duration of Market Access Loss

This box surveys the theoretical and empirical literature on the relationship between creditor losses in a restructuring and duration of subsequent market access loss. While the theoretical relationship is ambiguous the available empirical literature finds that light restructurings have a smaller, if any, impact on market loss, compared to deeper restructurings.

The theoretical literature on the effect of a restructuring on duration of market access loss is ambiguous:

- Some papers argue that markets "forgive and forget" following defaults, so market re-access should not be severely hampered by the extent of creditor losses. If a deep restructuring credibly establishes debt sustainability, new lenders have much better prospects of being repaid. Some suggest that, in forming expectations about future sovereign behavior, lenders differentiate restructurings that are "excusable," because they are associated with implicitly understood contingencies, from those that involve unjustifiable repudiation of debt servicing expectations. Thus, situations can arise when lenders consider that a borrower is justified in modifying its debt servicing obligations because the realized state of the world has turned out to be unusually bad for the borrower (Grossman and van Huyck, 1988).

- Other papers develop theoretical arguments that large haircuts signal a dishonest government, i.e., one that is inclined to expropriate creditors, thereby prolonging market access loss (Cole and Kehoe, 2000). A default can also be associated with negative private information of the government about the future state of the economy, hence deterring investors from re-entering the sovereign debt market (Sandleris, 2008).

Given the theoretical ambiguity, there is a rich empirical literature examining the impact of creditor losses in restructurings on duration of market access loss. The papers vary in terms of empirical methodology. To measure creditor losses, some papers use actual losses (Cruces and Trebesch, 2013) while others use a binary restructuring/default indicator. The literature also uses different complementary measures to assess market access loss: (i) individual syndicated loans and bond issuances in international markets (e.g., Eichengreen and Portes, 2000; Gelos and others, 2011); (ii) aggregated capital flows (e.g., Richmond and Dias, 2009); and (iii) a combination of both loan and bond issuances and aggregated capital flows (e.g., Cruces and Trebesch, 2013).

The available empirical literature finds that light restructurings have a smaller, if any, impact on market access loss compared to deeper restructurings:

- Some papers find that countries are able to regain market access soon, irrespective of whether the restructuring was light or deep. Gelos and others (2011) find that the probability of market access is not influenced by a country's frequency of defaults and is not significantly reduced if the default is quickly resolved. They also find that the average time needed to re-access international markets after a restructuring has fallen over time from an average of 4 years during the 1980s to 2 years during the 1990s. Similar results are obtained by Alessandro and others (2011), who find a 50 percent probability of market re-access within 4 years of a restructuring. Other studies, such as Eichengreen and Portes (2000) and Sandleris (2012), find that countries' market access is usually quick after a default event and is not associated with extent of creditor losses (e.g., Richmond and Dias, 2009).

Other papers find that market re-access is quicker in countries that impose smaller losses on creditors and longer in deeper restructurings. Cruces and Trebesch (2013) find that a one standard deviation decrease in haircuts is associated with a 50 percent higher likelihood of re-accessing international capital markets in any year after the restructuring. Moody's (2013) examine 36 sovereign bond exchanges since 1997 and find that the duration of the market access loss was proportional to creditor losses imposed on investors during the restructuring.

Box 3. Impact of Sovereign Debt Maturity Extensions on Domestic Bank Balance Sheets

This box examines several past maturity extensions (Cyprus, Jamaica, Pakistan, and Uruguay) and finds that they did not have destabilizing effects on the banking system.[1] Staff reports and other sources were examined for each case to obtain information on the banking system impact. The criteria used to assess whether the bond exchange had a material impact on the banking sector were to assess if, as a direct result of the bond exchange, any bank in the country needed either additional provisioning or recapitalization. A number of factors contributed to achieve a financial stability friendly maturity extension: domestically held debt was excluded from reprofilings in some cases, banks mainly held their sovereign assets as held-to-maturity (HTM), the rating downgrade to 'SD' was short-lived (less than two months except Pakistan with 11 months), regulatory incentives for banks (e.g., Jamaica or Uruguay) were provided, capital and liquidity support mechanisms were established (e.g., Jamaica) or were present (e.g., Cyprus) and some forbearance was used.

- Cyprus (2013): A few weeks ahead of when its bonds were originally due, Cyprus exchanged them with new bonds in the same amount and with the same terms. The main reason Cypriot banks did not have to book losses during the bond exchange was that banks had classified the affected sovereign bonds as HTM and they assessed, with the possible tacit consent of the regulator, that there was no impairment event. This allowed Cypriot banks to maintain the newly exchanged bonds as HTM and not move them to the Available for Sale (AFS) portfolio with the according fair value measurement (as market prices were well below par). The temporary SD assessment of the rating agencies did not bind Cypriot banks to book losses with the affected sovereign bond holdings as the sovereign did not default on its payments and issued new bond with the same face value and other terms. Finally, the prior bail-in of bank creditors closed the imminent capital hole of the main Cypriot banks.

- Jamaica (2010, 2013): Overall, the size of both bond exchanges was limited to ensure that the losses incurred would not destabilize the financial system. In both bond exchanges banks mainly held the involved domestic debt as HTM, and as there was no impairment event, they did not take any immediate additional provisioning or capital hit from the debt reprofiling exercise. Rating agencies ruled Jamaica's domestic government debt as SD but then upgraded the sovereign following the successful completion of each bond exchange. A Financial Sector Stability Fund (FSSF), that was set up to help with any capital and liquidity support for financial institutions was not tapped (see Grigorian and others, 2012).

- Pakistan (1999): Pakistan's restructuring of external sovereign debt in November 1999 had a limited impact on the domestic banking sector. The restructuring involved a slight nominal increase in principal outstanding for two of the three Eurobonds to roll in unpaid interest and the offered terms were relatively attractive to creditors. About 30 percent of restructured bonds were held by domestic investors. One participating domestic bank received a capital injection 6 months after the exchange following a bank audit, though the undercapitalization does not seem to be related to the earlier bond exchange.

- Uruguay (2003): The overall immediate direct impact on the domestic banking system from the domestic and external bond exchange in 2003 was small. More than 50 percent of the bonds were held by domestic creditors, mostly retail investors, while domestic bank holdings of government bonds were relatively low, at less than 5 percent of total bank assets and mostly held as HTM. The fact that domestic banks were mostly holding the sovereign debt as HTM did not matter since the bank supervisor provided strong regulatory incentives for banks to participate in the exchange.

---

[1] This box summarizes the main findings of Annex IV.

Box 4. Debt Reprofiling in Past Fund-Supported Programs

Reprofilings—face-value preserving maturity extensions with moderate NPV reduction—have been used in past Fund-supported programs and have been an effective instrument when used in the appropriate context. Their ultimate success depended on program implementation and the external environment. In most cases over the past decade or so, these reprofiling operations supported Fund programs with normal access limits—outside of the 2002 exceptional access framework.

When debt sustainability was uncertain or countries faced liquidity problems, reprofiling proved to be a key element of a definitive solution to debt problems provided program implementation was strong:

- Pakistan (1999) was facing both short-term liquidity and medium-term debt sustainability problems before its debt was reprofiled. While the Fund-supported program was seen as fully financed with debt rescheduling, debt sustainability was not assured. Staff noted that an external debt strategy would need to resolve both the short-term foreign exchange liquidity problems and medium-term debt sustainability. In tandem with Paris Club debt relief, the reprofiling provided breathing room and permitted debt ratios to improve.

- Uruguay (2003) stands out as an example of reprofiling in the context of a Fund program with exceptional access (access was approved before the 2002 framework became effective). Debt sustainability was presented as the main risk to the program. The debt-to-GDP ratio at the time of the debt operation was about 100 percent. Even at the time when the debt exchange was proposed, staff recognized that the fragile outlook could be derailed by any unforeseen shock. By 2008, debt levels had fallen by close to 60 percentage points helped by strong program implementation and a favorable external environment.

- Less often, reprofiling was used when debt sustainability was not at risk. In the Dominican Republic (2005), staff diagnosed the problem as one of liquidity and considered external debt to be sustainable over the medium term. The reprofiling was used as a means to finance the residual gap of the program.

On the other hand, reprofiling was not used successfully in cases where debt was too high or financial stability concerns dictated its use:

- In Grenada (2005), debt was recognized as unsustainable and the Board "urged the authorities to reverse over the medium term the recent sharp and unsustainable increase in debt." The reprofiling was seen as "a critical element of a comprehensive economic program aimed at returning the country to a position of economic stabilization and sustainability" (IMF Country Report No. 04/405). After the reprofiling, the adjustment envisaged under the Fund program was expected to bring public debt on a sustainable path; but instead debt continued to grow. A recent Ex-Post Assessment concluded that "Progress toward addressing fiscal vulnerabilities was limited and debt sustainability was not attained" (IMF Press Release No. 14/29).

- When Jamaica reprofiled its domestic sovereign debt in 2010 (external debt was excluded from debt operations), it was explicitly recognized that the 2010 debt exchange was not a definitive end to the country's problems but that deeper restructuring would have jeopardized financial stability. Staff noted that "given Jamaica's debt overhang problem, public debt sustainability risks remain high" (IMF Country Report No. 10/267). Public debt was expected to decline under the Fund program, but it failed to do so and public debt sustainability risks remained high. A subsequent program also required further debt reduction and even though the debt level remained high, reprofiling was again used in 2013 with financial stability again preventing more aggressive treatment. Debt overhang continues to pose risks to sustainability in Jamaica.

Box 4. Debt Reprofiling in Past Fund-Supported Programs (concluded)

Macroeconomic indicators around the time of reprofiling

	T-3	T-2	T-1	T	T+1	T+2	T+3	T+4	T+5
Pakistan (1999)									
GDP growth (percent)	6.6	1.7	3.5	4.2	3.9	2.0	3.1	4.7	7.5
Primary Balance (percent of GDP)	-0.7	0.1	0.0	1.7	1.9	2.1	1.8	3.8	1.6
Public Debt (percent of GDP)	68.0	68.8	69.4	75.2	77.0	79.0	73.6	68.2	61.5
Uruguay (2003)									
GDP growth (percent)	-1.8	-3.5	-7.1	2.3	4.6	6.8	4.1	6.5	7.2
Primary Balance (percent of GDP)	-1.2	-0.9	0.2	3.0	3.8	4.0	3.7	3.6	1.4
Public Debt (percent of GDP)	n/a	54.9	109.6	111.5	93.5	83.9	75.7	68.0	67.7
Dominican Republic (2005)									
GDP growth (percent)	5.8	-0.3	1.3	9.3	10.7	8.5	5.3	3.5	7.8
Primary Balance (percent of GDP)	-0.9	-2.7	-1.3	0.5	0.1	1.7	-1.4	-1.6	-0.6
Public Debt (percent of GDP)	24.6	52.3	38.4	41.3	38.6	35.5	35.3	37.9	38.8
Jamaica (2010)									
GDP growth (percent)	1.4	-0.8	-3.4	-1.4	1.4	-0.5			
Primary Balance (percent of GDP)	7.9	4.9	6.2	4.6	3.2	5.4			
Public Debt (percent of GDP)	114.5	127.0	141.4	143.2	141.6	146.1			
Grenada (2005)									
GDP growth (percent)	0.7	3.7	1.3	0.9	2.9	1.4	-0.8	-3.4	-1.4
Primary Balance (percent of GDP)	6.1	10.5	10.2	9.9	7.1	7.9	4.9	6.2	4.6
Public Debt (percent of GDP)	118.4	123.1	119.9	119.3	117.1	114.5	127.0	141.4	143.2

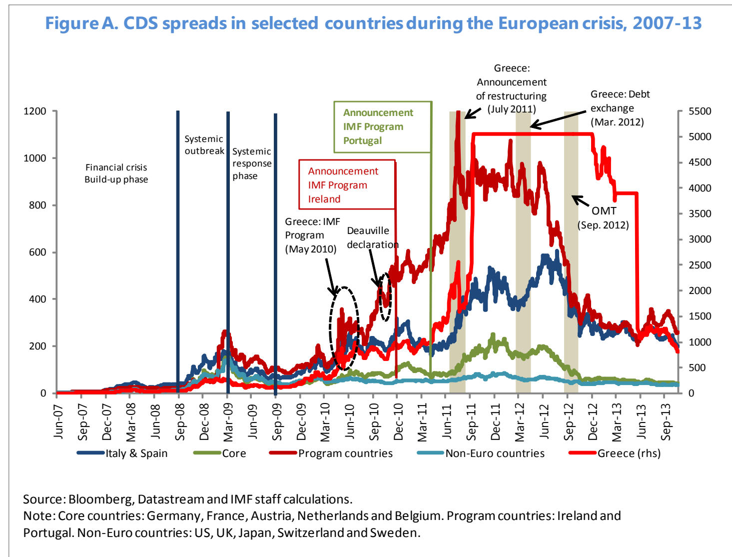
Source: World Economic Outlook (January 2014).

Note: 'T' denotes the date of completion of the exchange

Box 5. Contagion in Past Restructuring and Reprofiling Cases

Analyzing the evolution of contagion in past cases of sovereign distress can provide useful insight into its causes and suggest effective ways of containing it. Many factors drive contagion beyond the policy choices to resolve sovereign distress—including exogenous shocks, country size, magnitudes of exposure to and from the country in sovereign distress, policies in affected countries and supranational actions (especially in currency unions)—which may affect both the source country of contagion and the recipient countries. Experience in Argentina, Uruguay, Russia and recent events in Europe yields some interesting insights.[1] As shown in Annex III, contagion appears to be higher in the debt reduction than reprofiling cases based on the sample that was analyzed.

Figure A. CDS spreads in selected countries during the European crisis, 2007-13

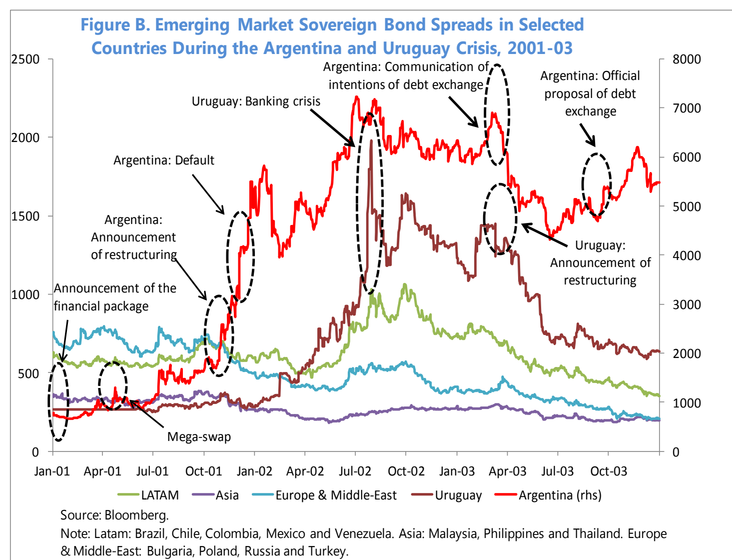


Source: Bloomberg, Datastream and IMF staff calculations.
Note: Core countries: Germany, France, Austria, Netherlands and Belgium. Program countries: Ireland and Portugal. Non-Euro countries: US, UK, Japan, Switzerland and Sweden.

- **Bailing out private creditors does not eliminate the risk of contagion though it may provide a short-lived relief.** For example, In Greece and Argentina, paying out creditors at the time of the approval of their Fund-supported programs did not contain contagion (here proxied by the co-movements of spreads)—a sign that these solutions lacked credibility (Figures A and B). Similarly, following payments to Russia's creditors accompanied by the July 1998 Fund-supported program, the Russian default a few weeks later triggered substantial contagion (Figure C).

- **Policy uncertainty appears to play an important role in driving contagion risks, and decisive policy actions have been instrumental in reducing them.** Contagion risks appear to rise during periods of uncertainty and seem highest before clear policy action is undertaken. In Greece, contagion risks rose throughout 2010 and 2011 while private sector involvement was in doubt. In Uruguay, spillovers from the Argentinean crisis increased co-movements in spreads.

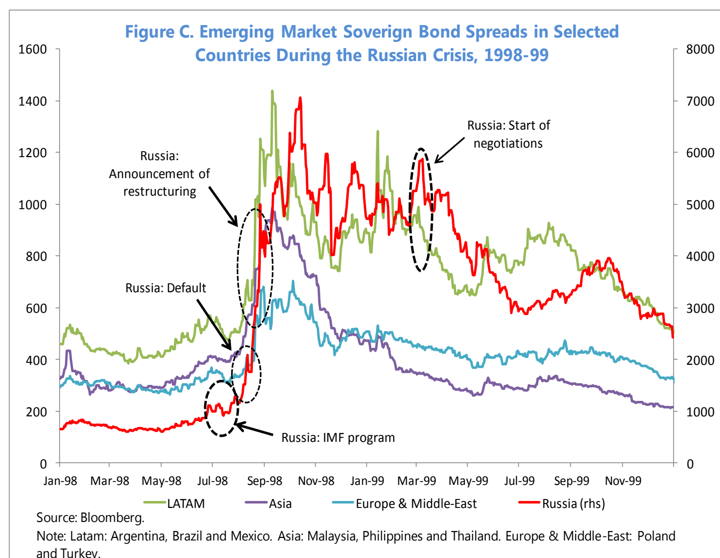
Figure B. Emerging Market Sovereign Bond Spreads in Selected Countries During the Argentina and Uruguay Crisis, 2001-03



Source: Bloomberg.
Note: Latam: Brazil, Chile, Colombia, Mexico and Venezuela. Asia: Malaysia, Philippines and Thailand. Europe & Middle-East: Bulgaria, Poland, Russia and Turkey.

Box 5. Contagion in Past Restructuring and Reprofiling Cases (concluded)

- **Once policy actions that diminished uncertainty were undertaken however, contagion risks declined—as illustrated by the decoupling of spreads—though with flare-ups in some cases that required renewed policy action.** In Russia, Uruguay and Greece, the co-movement of spreads started to decline following the announcement of restructuring, and sovereign spreads themselves began falling with either the start of negotiations or completion of the exchange.



Source: Bloomberg.
Note: Latam: Argentina, Brazil and Mexico. Asia: Malaysia, Philippines and Thailand. Europe & Middle-East: Poland and Turkey.

- **Policy actions by crisis countries alone did not bring down contagion sustainably.** In Russia, exogenous factors—the recovery in commodity prices—helped mitigate the effects of the crisis. In some cases, policy action was also need to reduce uncertainty about affected countries' resilience to the distressed sovereign. In the Euro area, the decisive ECB OMT and other supranational actions—including establishing firewalls with the ESM and launching the Banking Union—were crucial steps in restoring confidence in Greece and other peripheral countries. Thus, contagion seems to have had more to do with the precedent-setting nature of the policy actions taken to handle Greece as a member of the currency union than with contagion from exposure to Greece.

____

[1]This box summarizes the findings of Annex III.

Box 6. A Framework for Assessing Market Access Loss

The following indicators could be used to help determine whether a country has lost market access at the time of program request. The indicators below would be used to assess whether the country has lost market access or whether this loss is imminent. These indicators would be assessed covering a period of at least 24 months, subject to data availability, and combined with judgment, taking into account country-specific characteristics and conditions. While these indicators pertain to whether a member has already lost market access, a related assessment pertains to whether the loss is expected to be short-lived. As explained in the text, that judgment would be made in the context of the debt sustainability analysis (DSA) using the Fund's standard framework.

- Sovereign spreads: conduct a DSA scenario to assess whether debt would become unbounded if spreads are maintained at recent levels and also compare changes in the country's spreads to other sovereign spreads within the same asset class.
- Patterns of recent primary market bond issuances: Examine whether there have been significant departures in recent primary bond issuance practices (in terms of volume, frequency, maturity and financing terms) from what the sovereign would normally do when it has market access:
- Volume: Compare with (i) total financing needs; and (ii) preannounced bond auction schedule;
- Frequency: Compare with (i) average frequency of issuances; and (ii) bond auction schedule (e.g., if auctions are cancelled or delayed);
- Maturity: Compare with average original maturity of instruments
- Financing terms: Compare recent financing terms with past placements (e.g., if there is a shift from fixed interest rates to variable rates).
- Nonresident holding of public debt: Examine whether there has been a significant and sustained fall in nonresident holdings of public debt.
- Government bond rollover rates: Examine whether government bond rollover rates have fallen on a sustained basis. As a corollary, assess the extent to which there is greater reliance on nontradable instruments (e.g., retail instruments and directly placed instruments such as commercial papers and medium-term notes) to meet financing needs.
- Government cash balances: Examine whether there has been an abnormal decline in government cash balances.
- Sovereign credit ratings: Observe changes in ratings and assess whether the country has lost creditworthiness (e.g., if sovereign rating is downgraded to sub-investment grade in the past 12 months).

Bond trading activity: Assess the volume of recent bond trading in secondary markets and bid-ask spreads (e.g., if trading volumes are thinner and limited and bid-ask spreads wider).

References

Alessandro, Mauro, Guido Sandleris and Alejandro Van Der Ghote, 2011, "Sovereign Defaults and the Political Economy of Market Reaccess," Business School Working Papers 2011–08, Universidad Torcuato Di Tella.

Brooke, Martin, Rhys Mendes, Alex Pienkowski, and Eric Santor, 2013, "Sovereign Default and State-Contingent Debt," Bank of England Financial Stability Paper No. 27.

Cole, Harold L., and Timothy J. Kehoe, 2000, "Self-Fulfilling Debt Crises," Review of Economic Studies, Vol. 67(1), pp. 91–116.

Cruces, Juan J., and Christophe Trebesch, 2013, "Sovereign Defaults: The Price of Haircuts," *American Economic Journal: Macroeconomics,* Vol. 5(3), pp. 85–117.

Eichengreen, Barry, and Richard Portes, 2000, "Debt Restructuring with and without the IMF," unpublished manuscript, London Business School.

Gelos, Gaston R., Ratna Sahay, and Guido Sandleris, 2011, "Sovereign Borrowing by Developing Countries: What Determines Market Access?" *Journal of International Economics,* Vol. 83 (2), pp. 243–54.

Grigorian, David A., Trevor Alleyne, and Alejandro D. Guerson, 2012, "Jamaica Debt Exchange, IMF Working Paper 12/244, (Washington: International Monetary Fund).

Grossman, Herschel I., and John B. van Huyck, 1988, "Sovereign Debt as a Contingent Claim: Excusable Default, Repudiation, and Reputation," American Economic Review, Vol. 78(5), pp. 1088–97.

International Monetary Fund, 2013, "Sovereign Debt Restructuring—Recent Developments and Implications for the Fund's Legal and Policy Framework," (Washington).

Moody's, 2013, "Market Re-Access and Credit Standing After Sovereign Default," Sovereign Default Series.

Richmond, Christine, and Daniel A. Dias, 2009, "Duration of Capital Market Exclusion: Stylized Facts and Determining Factors," Anderson Graduate School of Management (UCLA) Working Paper (unpublished).

Sandleris, Guido, 2008, "Sovereign Default: Information, Investment and Credit," Journal of International Economics, Vol. 76(2), pp. 267–75.