MACROECONOMICS, TRADE AND INVESTMENT

EQUITABLE GROWTH, FINANCE & INSTITUTIONS NOTES

Achieving Comparability of Treatment under the G20's Common Framework

Diego Rivetti

WORLD BANK GROUP

The objective of the Common Framework (CF) is to design and implement a debt restructuring package that can fill a debtor's financing gap in the short-term and restore its debt sustainability in the medium-long term. To achieve this dual goal, a CF treatment should be accepted by both official bilateral and commercial creditors, who have different portfolios, incentives, and restructuring practices. The current CF architecture relies on the application of the Paris Club's (PC's) principle of comparability of treatment (CoT). However, CoT - in its current form – is not being enforced, does not distribute the burden of debt reduction equally among creditors, and does not guarantee compliance by private creditors, except for "light" restructurings. This note proposes two main reforms to address this challenge: (i) carrying out coordinated and simultaneous negotiations across creditors and (ii) using NPV reduction based upon a common discount rate as the only measure of CoT.

CoT: PC's definition and enforceability

CoT is the PC's principle aimed at assuring PC members that their claims are not subordinate to those of private institutions or other bilateral lenders that do not belong to the group.[1,2] The CoT is assessed *ex-post* by the PC on the basis of *one or more* of the following parameters:

a. Change in nominal debt service over the consolidation period.[3] The PC refers to "a strict proportional breakdown of the efforts among creditors" i.e., each creditor should contribute to bridging the financing gap proportionately with the maturities (in principal and interest) falling due over the consolidation period;[4] (See example in Figure 1)
b. Debt reduction in NPV terms. In its methodological note, the PC maintains that a single discount rate should be used for all creditors to ensure comparability.
c. Extension of the duration of the treated claims. The duration is measured in absolute terms (years) rather than relative to the duration of the original claims.

The discretional use of one or more of the above indicators gives the PC significant leeway in determining whether CoT is achieved. As a result, CoT has been generously evaluated, often considering country-specific mitigating factors,[5] even when greater levels of debt relief were granted by official creditors relative to private creditors.[6] In fact, Schlegl et al. show that, in past restructurings, the average difference in NPV reduction between the official and the private creditors is greater than 20 percentage points.[7] Yet, the Paris Club has never withdrawn a debt treatment on comparability grounds.[8]

Moreover, the timing of the agreements with private creditors does not suggest alignment with the CoT's request. Private restructurings may occur years after the PC's treatment. In some cases, a deal with bondholders was achieved before the PC's decision (e.g., Ukraine, Russia, or Ecuador).[9]

The heterogeneity in CoT outcomes and the timing of the official vs. private relief signal that **CoT's "moral suasion" has not been the key driver in the negotiations of the borrower with its private creditors.** Private creditors' goal is to maximize their financial recovery. Therefore, the key drivers in their restructuring strategies are the following: (i) the default status, with resulting missed cash-flows and mark-to-market losses in their balance sheets, (ii) the assumptions on the length of the restructuring process, (iii) the expectation on the future pricing of the restructured instruments and (iv) the ability to enforce the borrower's payment obligation.[10]

1. Although *de facto* in place throughout the history of the PC, the CoT principle was officially introduced with the Evian approach in 2004.
2. The wording currently in use is the following: "In order to secure comparable treatment of its debt due to all its external public or private creditors, the Government of X commits to seek promptly from all its bilateral and commercial external creditors debt reorganization arrangements on terms comparable to those set forth in these Agreed Minutes, while trying to avoid discrimination among different categories of creditors. Consequently, the Government of X commits to accord all categories of bilateral and commercial creditors -and in particular creditor countries not participating in these Agreed Minutes, and private creditors- a treatment not more favorable than that accorded to the Participating Creditor Countries".
3. In PC's taxonomy, the consolidation period is the period during which debt service falling due (principal and interests) is restructured. It typically corresponds to the period of the IMF program, which must show a financing gap that can only be covered by debt rescheduling.
4. In some past cases, arrears accumulated as of the start of the consolidation period have been also treated.
5. "Exceptions can be made, for example, when the debt only represents a small proportion of the country's debt burden and when restructuring would unduly interfere with the smooth running of trade." (www.clubdeparis.org).
6. See the cases of Ukraine (2000), Pakistan (2001) or Jordan (2004).
7. Schlegl M., Trebesch C., Wright M., The Seniority Structure of Sovereign Debt (2019). CESifo Working Paper No. 7632, available at SSRN: https://ssrn.com/abstract=3387668.
8. Claw-back provisions are not included in PC's MoUs. Therefore, the main disincentive for borrowing countries to breach CoT is the risk of jeopardizing the implementation of the IMF program, rather than the possible cancellation of the PC's agreement.
9. These cases have raised the call for "reverse comparability" (i.e., PC accepting the terms of the private debt relief on CoT terms), which the PC has rejected.
10. For instance, in the case of Chad, the request for CoT is difficult to enforce, as the debt of the main commercial creditor (Glencore) is collateralized by oil revenues and has been regularly serviced

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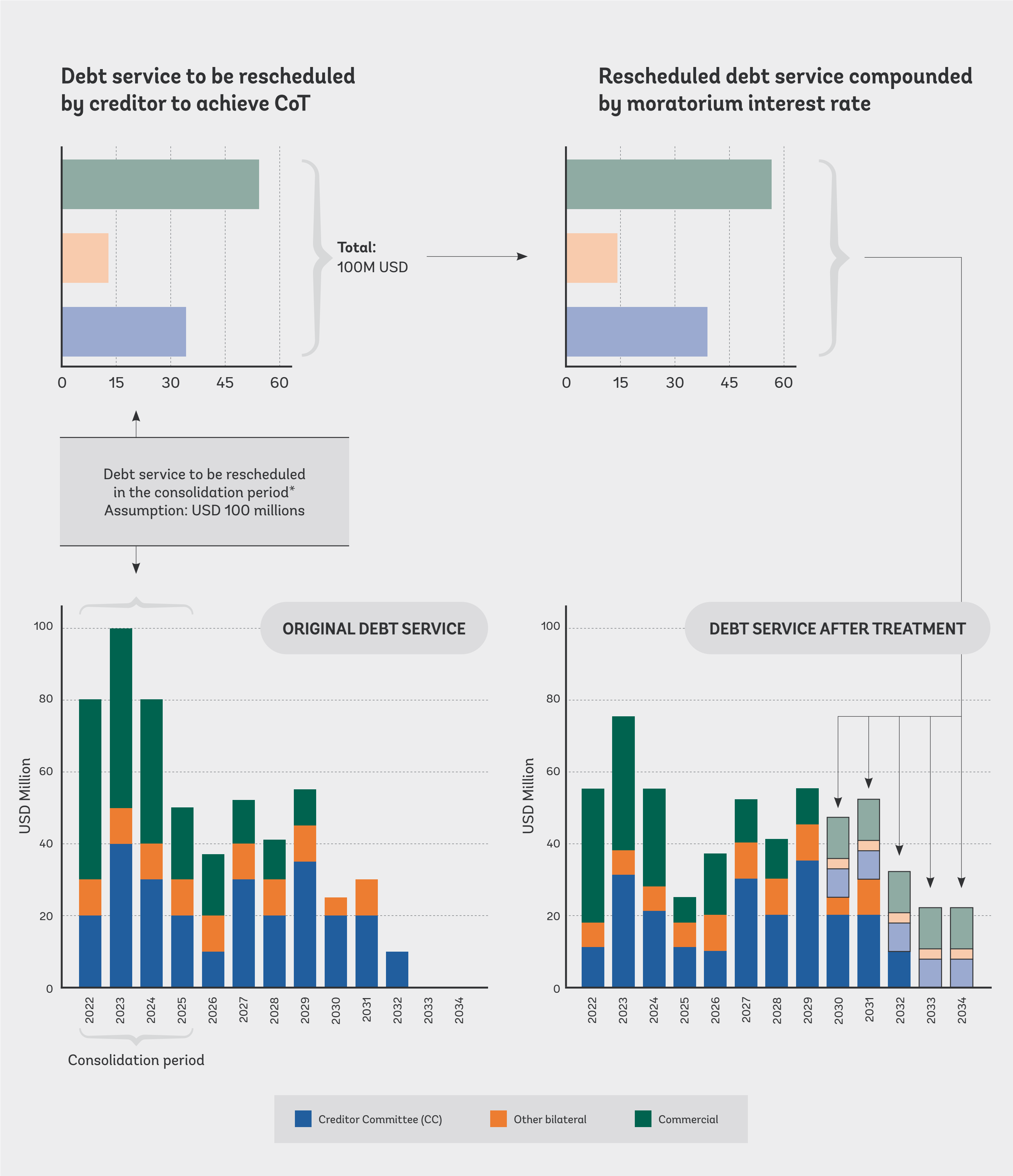
FIGURE 1 - Example of a Paris Club's "flow treatment"



* Calculated as the difference between the funding needs and the identified borrowing sources in the consolidation period

Main limitations of PC's approach and proposed reforms

This finding calls for a significant reform of the current CF process, which is based on a two-step approach i.e., first reaching a debt relief commitment from the Creditors' Committee (CC), then requiring the borrowers to seek relief from commercial creditors on the basis of CoT. The limitations of the current approach are the following:

a. It extends the length of the overall negotiation phase, as private creditors are not given any indication of the CC's restructuring terms until the terms are confirmed in the CC's Memorandums of Understanding (MoUs).
b. It increases the likelihood of "light" restructurings (i.e., rescheduling of debt service with limited or no NPV reduction) and consequently the recurrence of debt distress, as CC creditors are not likely to commit to a deep relief in the absence of any similar assurances from the private creditors.

As a result, the CF should consider **joint (or at least simultaneous and coordinated) negotiations across key creditors.**[11] This is critical given the significant share of commercial debt in CF's eligible countries[12] and the resulting lack of leverage of the official creditors over private creditors.[13] This reform can also help overcome the challenge of the different definitions of official and commercial debt across creditors. At the minimum, the CC should be open to share and discuss any relevant analysis (e.g., DSAs, calculation of the restructuring envelope, simulation of the restructuring parameters) with commercial creditors as soon as they become available.

CoT based only on NPV reduction

The challenge of identifying a methodology for assessing CoT remains even if the proposed simultaneous and coordinated approach to debt restructuring were to be adopted. The broad-based and discretionary ex-post interpretation of CoT applied thus far by the PC might have been driven by pragmatic motivations, but does not serve well the CF, given the higher level of scrutiny and the severe reputational risk in case of non-compliance.

To assess CoT *ex-ante*, preference should be given to **NPV reduction** among the three indicators currently used by the PC, as:

a. It captures the impact of changes in the other two indicators (i.e., changes in debt service cash-flows and duration extension).
b. It is relevant for both rescheduling ("flow treatment") and restructuring with nominal haircut ("stock treatment"), as opposed to the other two indicators which could be used only to assess the former.
c. It is not affected by duration-bias. On the contrary, setting a "consolidation period" for debt restructuring makes the treatment dependent on the duration of the original claims (i.e., any principal payment falling beyond the consolidation period is not subject to restructuring).
d. It is widely used by financial market participants. In private restructurings, fair burden sharing is achieved by targeting equal NPV reduction across the outstanding instruments in the restructuring perimeter.

There are two methods of computing NPV reduction:

1.

$$\text{NPV reduction} = 1 - \frac{\text{PV of the new debt}}{\text{FACE VALUE of the old debt}}$$

2.

$$\text{NPV reduction} = 1 - \frac{\text{PV of the new debt}}{\text{PV of the old debt}}$$

11. E.g., committee representing Eurobonds' investors or largest private sector creditors
12. In the case of Chad, Ethiopia, and Zambia, the ratio of commercial debt over bilateral debt is respectively 126, 77, and 141 percent (Source: International Debt Statistics, World Bank, 2022)
13. In Chad, assuming a 2022-2024 consolidation period, one creditor (Glencore) is expected to provide 80 percent of the debt relief in nominal terms, on the basis of the debt relief targets set by the creditors providing the remaining 20 percent.

The difference between the two is the denominator (old debt), which in (1) is taken at face value, while in (2) takes into consideration the debt's redemption profile.
Equations (1) and (2) yield the same result for financial market participants as a metric of cross-creditor comparability because bond/loan payments are typically accelerated at default and therefore their maturity profiles are no longer relevant. However, for the purpose of CoT between private and official creditors, equation (2) provides the most appropriate metric, as equation (1) would unfairly over-value official claims (i.e., to achieve CoT, the different level of concessionality of the original instruments must be valued).

Single discount rate to be used in CoT calculations

The choice of the discount rate is crucial in the NPV calculation and involves some level of discretionality. However, assuming that equation (2) is followed, the choice of the discount rate would only affect the contribution of interest rate reductions relative to maturity extensions (nominal haircuts are neutral to discount rates). In other words, the higher the discount rate, the higher the incentives for the creditors to achieve the same level of NPV reduction through maturity extension as opposed to interest rate reduction.

In light of this, the use of "exit yields" (or a proxy for a post-restructuring market yield, to be agreed upon during the negotiation phase) is advised, as it has the additional advantage of providing a benchmark for comparability across private creditors (e.g., bondholders). Nevertheless, two caveats should be raised:

a. NPV reduction should be calculated on the entire debt stock for each category of creditors (as opposed to targeting only the debt falling due in the consolidation period).
b. If any debt service were to be brought forward to a future date (for instance, because of a standstill) the same discount rate should be used. This point would alter the PC's practices of compounding rescheduled amounts at discretionally defined "moratorium interest rate".

Conclusions

This note proposes to replace the existing discretionary methodology for CoT assessment with the single, transparent indicator of NPV reduction based upon a common discount rate of the borrower's "market exit yield" or a proxy of the cost of debt post-restructuring.

To be effective, this reform should also be accompanied by a revision of the CF procedures to implement simultaneous and coordinated negotiations across key creditors, as opposed to the current two-step approach.

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