POLICY BRIEF

Domestic Debt Restructuring: An exercise in Laser Surgery

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Executive Summary

*The **key messages** based on Lazard's experience of advising governments dealing with debt problems:*

- *Domestic Debt Restructurings (DDR) may be necessary when there is a lot of Domestic Debt (DD) and when the effort required from external commercial creditors to put the debt back on sustainable grounds is exceedingly demanding. And ultimately self-defeating.*
- *Yet, even in those circumstances, conducting a DDR requires extra care*
- *Indeed DDR can create second round and even third round effects that thwart their expected benefits*
- *There is a Laffer curve of the benefits of a DDR for external commercial creditors as a DDR may end up weakening repayment capacity*
- *Overall, if a DDR is judged necessary, treatment of commercial banks require exceptional prudence, and prefer inflicting NPV rather than nominal losses, including through adjustment to accounting conventions*

1. In any sovereign debt restructuring, one of the first and key questions is the perimeter of the contributing creditors. For instance, the debt owed to the IMF and to most MDBs is excluded for (justified) policy reasons. This means that the quantum of debt relief will have to shared amongst the remaining creditors. This is in this context that the public debt owed to domestic creditors in local currency may be viewed as a candidate for restructuring. External commercial creditors may indeed want to spread the effort in the hope of **obtaining higher recoveries.**

2. But involving domestic creditors into a debt restructuring raises entirely different problems. External debt restructurings consist in inflicting losses to foreign economic agents; domestic debt restructurings consist in inflicting losses to domestic savers, consumers, taxpayers and depositors, undermining the foundational illusion that government debt is risk-free.

3. So a DDR adds a second round economic and financial effect to the restructuring, with potentially unintended consequences. To the extent it affects negatively the capacity to pay of the government, it triggers an undesirable circularity.

4. Therefore, far from reducing the losses inflicted to the external shareholders, it may increase the risk of a disruptive negative sum game of asset destruction. As a result, **external creditors, such as bondholders, should be careful of what they are wishing for when requesting some burden sharing with domestic creditors since this could lower the recovery value for everyone.**

5. Three questions arise when one envisages bringing domestic creditors into the debt restructuring process: **(i) is it inevitable? (ii) can it be done in a way that minimises second round effects? (iii) how, in practice, should 'comparability' amongst creditors be thought through?**

6. Is it inevitable?

From a debtor country's perspective, the difference between an external debt restructuring and a domestic debt restructuring is that the former is eventually dictated by the '**physical**' presence of foreign reserve currency (Dollar, Euro..) at the central bank, while the latter is more of **a policy choice.**

A DDR, as for itself, does not come from a material impossibility of using a policy tool: any government, in theory, can generate a primary surplus (to compensate a highly positive r-g), put pressure on its central bank to monetise debt or introduce some financial repression (containing upward pressures on r).

But of course each of these policy choices entail economic and political costs as well as unpleasant trade-offs so that DDR may eventually appear as a better alternative:

- Generating massive primary balances may hurt political consensus and the social fabrique, in addition to reducing disposable income;

- Forcing the central bank to monetise debt may generate (hyper)inflation, and will ultimately bring the exchange rate down, complicating foreign debt service;

- Financial repression may require effective administrative capacities, will suppress the role of markets in determining interest rates and will ultimately impose real losses on savers.

- Last, given the size of domestic debt, a DDR may be the sole way to get a comprehensive debt restructuring, notably in view of reaching IMF debt sustainability targets.

So while a DDR is rarely inevitable, a government may decide that the cost of not doing one exceeds the costs of doing one.

7. How to limit second round effects?

The question is: to what extent bailing-in domestic creditors exposes to negative and self-reinforcing economic and financial dynamics? **Strictly speaking, the issue is not so much whether the debt is "domestic" rather than whether it is owed to domestic agents whose loss absorbing capacity is insufficient to forestall negative feedback effects**. This raises two specific cases: local banks may hold external debt (foreign currency bonds), so that their shock absorption capacity may already be eroded by the External Debt Restructuring (Sri Lanka); or foreign creditors may hold local currency/local law government paper along with local banks, so that the financial stability imperative of protecting the latter may end up sparing the former from losses (Zambia).
Second round effects of a DDR are both well documented and extremely difficult to quantify. **One can think in terms of which domestic creditor may contribute and how.**

The domestic creditors are the commercial banking system, insurance companies and the pension system (asset owners) and the central bank.

The banking system is notoriously at the core of a destructive feedback loop so extra caution is required: the losses inflicted should not endanger financial stability, with a good margin of prudence. Beyond financial stability considerations, the question of the buyer of government paper in last resort in the wake of a debt restructuring — usually local banks — militates for a well thought-through strategy.

The pension funds are at the core of saving generation and management in the country: bailing-in them is very delicate, beyond obvious inter-generational issues. That said, given that their liabilities are long term, they can be helpful in helping face temporary liquidity problems.

Paradoxically, there is some (limited) room on the CB's balance sheet if only because people's confidence in the currency is not highly dependent on the size of the equity of the CB, which they usually ignore. But of course, if the accounting hole in the balance sheet has to be filled immediately by a State recapitalisation, there is no benefit. The key idea is that CB are not liquidity constrained in local currency and therefore the recap can be staggered.

Regarding the modus operandi, it is much safer to avoid inflicting direct nominal losses and much preferable to operate through financial repression and adjustments to accounting conventions.

8. In addition to the second round effects, it is also key to think about the more speculative but important **third round effects**: how will the country finance its development in the future if the banking system is severely wounded, the (supposedly) risk free asset in local currency has disappeared and domestic savings have been decimated? Although it is often nothing more than a comforting illusion, impairing what usually constitutes a local "safe asset" (government paper) can have enduring ripple effects to the entire financial system, disrupting risk measurement, liquidity and funding conditions and ultimately raising future government borrowing costs.

Table: DDR decision-making process illustrated by recent cases

	Zambia	Sri Lanka	Ghana
Can debt sustainability – as assessed by the IMF – be restored through a **realistic and politically feasible fiscal adjustment**?	✗✗✗	✗✗✗	✗✗✗
Based on fiscal adjustment, can debt sustainability – as assessed by the IMF – be restored through a **realistic external debt restructuring**?	✓	✗✗	✗✗✗
Based on fiscal adjustment and EXD restructuring, **is a Domestic Debt Restructuring ("DDR") required** to restore debt sustainability	**Uncertain**	**Yes (but only to meet liquidity thresholds)**	**Definitely (required to meet debt stock thresholds)**
How contained are the **risks to financial stability and government access to finance** in case of a comprehensive DDR?	• Risks to financial stability and associated deterioration in macro-framework > gains to external creditors from including foreign holders of domestic debt in external debt restructuring parameters(*)	• Risks to financial stability arising from banking sector fragility > expected benefits. Indeed, banks affected by pronounced recession and already exposed to foreign-currency debt restructuring	Risks to financial stability deemed contained due to strong shock absorption capacity and limited recession and thus < expected benefits. Also loss of domestic market access prior to the restructuring
Are there **specific domestic institutions that have larger loss absorption capacity and for which political acceptability of DDR is greater ?**		**Pension funds** **Central Bank**	**Local banks** **Central Bank**
Conclusions	• DDR not necessary to restore debt sustainability • DDR would not increase external creditors' recovery (higher burden sharing offset by deteriorated macro conditions)	• DDR required principally to meet DSA's liquidity thresholds • Domestic banks already exposed to restructured foreign-currency debt instruments and weakened by a large recessionary context • Risk-reward analysis point to no benefits in including banks' holdings of domestic securities in the restructuring • Pension funds and Central Bank can withstand maturity extensions allowing to meet liquidity thresholds	• DDR required to restore debt solvency • Loss absorption capacity of banks is large thanks to decades of large real interest rates and prior State-support to the banking system • Pension funds inclusion necessary for burden sharing purposes but cannot contribute to decisively meeting DSA targets
Decisions	**No DDR**	**Selected DDR**	**Comprehensive DDR**

(*) In the case of Zambia, IMF's LIC Debt Sustainability targets focus exclusively on external indicators (PV of external debt to exports and external debt service to revenue ratios), implicitly constraining the impact of domestic debt on debt sustainability and burden sharing among creditors to the issue of foreign holders of domestic debt (categorized as part of external debt as per IMF's residency-based measure of external debt)

9. How should comparability be thought through in a DDR?

DDR also raise complex issues of comparability amongst creditors:

- Should there be comparability of treatment between external and domestic creditors once the decision to involve domestic creditors has been taken?
- Should all domestic creditors be offered the same terms?
- How to ensure there are no holdouts?

10. Once a decision has been made to involve domestic creditors, should they be treated in a comparable way as external creditors? Most likely not, as the binding constraints in external and domestic restructurings are not the same. DDR should be thought of as a **residual** exercise to complete restoring debt sustainability after fiscal adjustment, financial repression and external debt restructuring have played their role, and under the constraints of political stability and preservation of the domestic financial infrastructure.

11. Should all domestic creditors be treated identically? In the case of external debt restructurings, different creditors have different classes of instruments reflecting their relative preferences (bonds, bilateral loans…). This heterogeneity allows to treat creditors differently, though in a comparable way. In a DDR, nearly all the creditors hold the same nature of claim: Treasury bonds.

Yet, this does not necessarily mean that the same solution should apply to all, banks, pension funds, or individuals etc… Indeed, each group of domestic creditor is subject to different accounting conventions, has different shock-absorption capacity and systemic impact and inevitably different bargaining power. This means that even though domestic creditors hold the exact same asset, some differences may be justified in the application of the debt treatment. That said, any distinction, creating relative winners and losers in the country, will have to be economically sound, politically justified and skillfully communicated.

12. Another issue of comparability in DDR is the risk of holdouts. In most cases, local instruments do not have Collective Action Clauses (CACs). Contrary to widespread views, issuing under local law — where the government is supposed to exert some degree of sovereignty — does not mean total latitude to change the rules of the game. There may be indeed strong legal or political impediments to retrofitting CACs. Also, CACs can be helpful in bringing in ‘dormant’ accounts, especially when there is a strong retail investor base, but cannot be a solution to coerce politically active groups.

In the absence of CACs, a ‘voluntary’ exchange, as it inflicts financial losses and is inevitably unpopular, is unlikely to be smooth. As a result, a menu of ‘carrots and sticks’ is needed. This can mean favorable regulatory treatments (for banks, insurance companies and pension funds), accommodating accounting adjustments etc…

13. If a DDR is considered as necessary/inevitable, what should be the ideal sequence between external and domestic debt restructurings? In the design of the debt restructuring strategy, the decision to launch a DDR should be viewed as a residual/complementary matter, second to the external debt restructuring. That does not mean though that a DDR should always come after the EDR. On the contrary: experience suggests that having a credible DDR option on the table when discussing with external creditors generates a lot of goodwill.

14. In conclusion, a DDR is a viable fall-back solution only when the second round macroeconomic and financial effects are expected to be muted or controlled, and when the third-round effects are thought through. In this case, a DDR works more safely through NPV losses (financial repression) than direct nominal losses.

Lazard's Sovereign Advisory Group is committed to serving its clients: governments and public institutions looking for solutions to their complex financial problems. The sheer scope and importance of these matters also compels us to share our decades of experience for the broad public interest.

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