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## FUND SUPPORT FOR DEBT- AND DEBT-SERVICE-REDUCTION OPERATIONS

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

- The **Staff Report** prepared by IMF staff and completed on February 3, 2021

The report prepared by IMF staff has benefited from comments and suggestions by Executive Directors following the informal session on February 19, 2021. Such informal sessions are used to brief Executive Directors on policy issues and to receive feedback from them in preparation for a formal consideration at a future date. No decisions are taken at these informal sessions. The views expressed in this paper are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board.

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**International Monetary Fund**  
**Washington, D.C.**



## Fund Staff Re-Examine the Case for Using Financial Incentives in Support of Debt Restructuring Operations

FOR IMMEDIATE RELEASE

**Washington, DC – March 16, 2021:** As part of an active work program on debt-related issues outlined in earlier [papers](#) and [blogs](#), Fund staff recently published a [paper](#) examining the economic case for Debt- and Debt-Service-Reduction Operations (DDSROs): cash payments (usually through market-based buybacks) or collateral offered as part of a debt restructuring offer. The paper analyzes the relevance of the Fund's 1990s policy on such operations to the present, post-COVID, context.

Under the Debt- and Debt-Service-Reduction (DDSR) policy, the Fund supported members' DDSROs by earmarking a portion of Fund financing to assist such members in making debt buybacks and collateral purchases. This policy was discontinued in 2000, two years after its last use.

Given the evolution of the sovereign debt landscape and broader Fund policies, staff does not see the need for reviving the DDSR policy at this juncture. If a member wants to finance DDSROs in the context of a Fund supported program, it could do so using the general balance of payment support provided by the Fund, without requiring a dedicated policy for DDSROs. However, while the paper identifies circumstances in which including cash or collateral in a debt exchange offer and/or buying back debt in the secondary market could contribute to resolving a member's balance of payments problems, the circumstances under which Fund resources could be used to support DDSROs are narrow. The Fund has not received any request for such support at this time.

While a systemic sovereign debt crisis is not in staff's baseline scenario, it remains critical to thoroughly review the toolkit available to address a potential crisis. The Fund and its staff will continue to make progress in this area in order to best serve its members.



February 3, 2021

## FUND SUPPORT FOR DEBT- AND DEBT-SERVICE-REDUCTION OPERATIONS

### EXECUTIVE SUMMARY

In the 1990s, the Fund supported members' debt- and debt-service-reduction (DDSR) operations by setting aside part of the Fund's financing to assist such members in making buybacks and collateral purchases. The purpose of the present note is to re-examine the economic case for such support in the present, post-COVID context and lay out some informal guidance that could help members and staff decide when such support is economically justified and what form it should take. The paper does not propose a new policy or a change in policy.

The note concludes that the Fund could support a member's use of buybacks, cash sweeteners, or collateral in the context of a Fund-supported program, provided that (i) debt restructurings using buybacks, cash sweeteners or collateral offer significant efficiency gains relative to debt restructurings that do not rely on such instruments, but are underpinned by a regular Fund-supported program; and (ii) an adequate cushion of non-multilateral debt remains after the operation. The conditions under which buybacks, cash sweeteners or collateral can be expected to deliver significant efficiency gains are narrow and specified in some detail.

Fund support of DDSR operations (DDSROs) under these conditions does not require a change in Fund policy. In particular, it can be undertaken without a revival of the Fund's 1989 policy on support of DDSROs, whose purpose was to specifically earmark a portion of Fund financing as part of the Fund-supported program for use in a DDSRO.

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## INTRODUCTION

**1. This note examines the case for Fund-financed credit enhancements and buybacks in the context of debt restructuring operations.** As argued in a recent staff note on the International Architecture for Resolving Sovereign Debt Involving Private-Sector Creditors,<sup>1</sup> the risk of a wider and deeper than expected sovereign debt crisis requires the Fund to re-examine its toolkit for confronting such crises. Financing for DDSROs played a role in resolving the last systemic sovereign debt crisis, that of the 1980s, but the tool has not been used since the late 1990s.

**2. This note asks two questions: (1) could it be appropriate for the Fund to support a member's use of buybacks, cash sweeteners or collateral in the context of a DDSRO under a Fund-supported program, and if so, under what conditions; and (2) should the Fund revive its (expired) 1989 policy on support for DDSROs to specifically earmark a portion of Fund financing for use in a DDSRO that adheres to certain criteria?** The answer to the first question is yes, but under narrow conditions. The answer to the second question is no, as the earmarking of resources for DDSR operations is viewed as unnecessary. The Fund provides financing to support a member's economic program designed to restore the member to medium term external viability; the member may use such financing consistent with that economic program. While the earmarking of Fund resources to finance DDSRO operations can have certain advantages, it also has disadvantages. Thus, no special policy or policy change is proposed at this time. Instead, the note develops a general framework to informally guide staff and members, describing the conditions under which Fund financing to support DDSROs might be appropriate—i.e., where DDSROs supported by Fund financing would help resolve a member's BOP problem.

**3. From 1989 until 2000, the Fund had a specific policy on support for DDSROs to partially finance members' expenses related to restructuring debts owed to commercial banks.** Under this policy, the Fund would lend to a member (in the context of a Fund-supported program) through program augmentation and set-asides, for the specific purpose of financing cash payments (usually through market-based buybacks) or collateral offered by the member as part of debt restructuring offer. The purpose of establishing a specific DDSR policy was to signal Fund support for certain types of DDSROs endorsed by the broader official sector and, for each specific operation, to catalyze participation by releasing financing once the contours of the operation had been agreed by the parties and had been assessed by the Executive Board to satisfy particular criteria (Annex I). The DDSR policy was part of a broader set of Fund policy reforms in 1989, in the context of the Brady Plan, aimed at resolving the emerging market debt crisis by facilitating market-based restructurings.<sup>2</sup> Under the policy, the Fund provided financial support to DDSROs on 11 occasions between 1989 and 1998 (see the below section on the Fund Experience with the DDSR Policy). The policy was terminated in 2000, two years after its last use.

<sup>1</sup>[The International Architecture for Resolving Sovereign Debt Involving Private-Sector Creditors—Recent Developments, Challenges, and Reform Options](#), September 2020.

<sup>2</sup>Other policy reforms undertaken at the time included the Fund's Lending into Arrears (LIA) policy.

**4. In the late 1990s, the Brady deals were succeeded by a new generation of debt restructurings focused on sovereign bonds.**<sup>3</sup> For the most part, these restructurings consisted of bond exchange offers implicitly or explicitly backed by the threat of non-payment. To help achieve the desired high participation, these offers typically used minimum participation thresholds, collective action clauses, as well as certain legal “sticks” (such as exit consents that removed legal protections from non-tendered bonds and made them harder to trade) and “carrots” (such as upgrades in governing law, or other contractual improvements).<sup>4</sup> In contrast, *financial* carrots, although often deemed essential to the success of the Brady deals, were only used rarely in post-1998 restructurings,<sup>5</sup> and none involved Fund financial support.<sup>6</sup>

**5. Possible similarities between the 1980s debt crisis that motivated DDSROs and a potential post-COVID debt crisis justify taking a fresh look at Fund-supported DDSROs.** If a systemic debt crisis were to arise in the wake of COVID (*not* the staff’s baseline expectation, but certainly a risk), this may require deep debt restructurings in an environment of high uncertainty, liquidity pressures, and risk aversion on the side of creditors. These are arguably conditions in which DDSRO financing proved useful in the past. Accordingly, a recent staff note on the international architecture for resolving sovereign debt involving private-sector creditors proposed to explore Fund financial support for DDSROs as an element of the Fund’s toolkit.<sup>7</sup> The use of officially supported buybacks and credit enhancements to forestall or resolve deep debt crises has also been recently proposed by a number of outside authors and institutions.<sup>8</sup> As such, the Fund should have a position on whether, and in what circumstances, Fund financial support for DDSROs might be appropriate.

**6. This note concludes that Fund-supported DDSROs may be appropriate if they *both* have clear advantages compared to standard debt restructurings backed by Fund-supported adjustment programs *and* leave in place an adequate cushion of non-multilateral debt.**

Efficiency gains that might justify DDSRO support could fall in three categories.

- First, cash or collateral may allow a debt exchange offer to succeed in circumstances in which other instruments to raise participation are unavailable or ineffective, because of the terms of

<sup>3</sup>See [Sturzenegger and Zettelmeyer \(2006\)](#), IMF ([2006](#), [2013](#)) and [Das et al \(2012\)](#).

<sup>4</sup>See [Bi et al \(2016\)](#), and [Buchheit et al \(2019\)](#).

<sup>5</sup>The World Bank’s Debt Reduction Facility (DRF) for IDA (International Development Assistance)-only countries, also established in 1989, was reviewed and its implementation arrangements were adjusted in 2004 to strengthen alignment with the HIPC Initiative and promote commercial creditor participation in the delivery of HIPC debt relief.

<sup>6</sup>The only cases that we are aware of are the Seychelles 2009 restructuring, in which the African Development Bank provided a partial guarantee of the country’s new bonds; the St. Kitts and Nevis’ 2012 restructuring, in which newly issued discount bonds benefited from a partial guarantee of the Caribbean Development Bank; and the Greece 2012 restructuring, in which almost two-thirds of the value of the securities bundle offered to creditor was provided through cash-like instruments provided by the European Financial Stability Facility (EFSF). For more details and references on the Greece and Seychelles cases, see Box 1 below. For more details on the St. Kitts and Nevis case, see [ECCB \(2012\)](#), pp. 8-11.

<sup>7</sup>See “The International Architecture for Resolving Sovereign Debt Involving Private-Sector Creditors—Recent Developments, Challenges, and Reform Options” ([IMF 2020](#)).

<sup>8</sup>See [Rashid and Stiglitz \(2020\)](#), [Naidoo \(2020\)](#), [Hugman et al \(2020\)](#), [IIF \(2020\)](#), among others.

debt contracts, or because of reputational constraints to applying “sticks” such as the threat of nonpayment.

- Second, offering cash or collateral could lead to higher debt relief compared to offering only (uncollateralized) bonds, as would be the case if creditors underprice such bonds (reflected in very high expected exit yields). Such underpricing could be the result of asymmetry of information about the debtor’s capacity and willingness to repay, extreme risk aversion, or lack of liquidity. These conditions might arise particularly in the context of a systemic debt crises, where creditors may face losses on multiple parts of their portfolio as well as heightened liquidity pressures, and hence may be willing to make larger concessions in exchange for cash.
- Finally, market-based debt buybacks financed by Fund lending could be appropriate if they meaningfully reduce either the debt burden or specific debt vulnerabilities (for example, related to rollover risk), while avoiding the costs of a debt restructuring (such as protracted negotiations and reputational costs).

**7. The potential benefits of DDSRO financing must be weighed against their risks and opportunity costs.** Financing dedicated to DDSROs will not be available for standard balance of payments support. Furthermore, both from the debtor’s and the Fund’s perspective, it is essential that the Fund’s post-DDSRO share of outstanding debt is not so large, relative to outstanding non-multilateral debt, as to complicate both future market access and any future debt restructuring. This implies that Fund-financed buybacks may not be large enough to resolve an unsustainable debt problem. As a result, buybacks could be useful mainly when sovereign risk is perceived to be high but debt is sustainable, or when debt is only “borderline” unsustainable. Deep sustainability problems should be resolved through negotiated debt restructurings, which may or may not involve “sweeteners” such as cash.

**8. This paper does not address several questions which, although related to its main topic, would require much deeper or broader analysis.** First, while the paper characterizes the conditions under which DDSROs might make sense in qualitative terms, it does not say how to empirically identify these conditions and does not provide operational guidance on how to structure DDSRO operations for maximum impact. Such guidance could be developed either in a follow-up paper or in the context of a specific case. Second, the paper examines the case for credit enhancements only in the context of debt restructuring operations. It does not address the case for enhancements to promote financial development or encourage private capital flows to countries with tenuous market access. Third, while the arguments developed in this note apply both to restructurings of external debt and domestic debt denominated in foreign currency, the latter are amenable to additional instruments and pose additional risks which are not covered in this note (but are analyzed in a forthcoming staff paper).

**9. The remainder of this note is organized as follows.** The next section presents the economic argument for Fund support of DDSROs and explains under what conditions Fund-supported DDSROs might be appropriate. The following section gives an overview of the Fund’s experience with the DDSR policy in the late 80s and 90s and an economic analysis of its advantages

and disadvantages. The paper then examines the case for reviving a dedicated DDSR policy and concludes that this is not needed. The final section concludes and presents issues for discussion.

## ECONOMIC RATIONALE FOR FUND-SUPPORTED DDSROs

### 10. This section describes the potential economic rationale for Fund-supported DDSROs.

This note will focus on two specific types of operations that could be pursued under Fund-supported programs: cash and (partial) collateralization of principal and interest to “sweeten” a debt exchange offer, and market-based buybacks—as supported by the IMF in the 1990s, and as recently proposed by Rashid and Stiglitz (2020) in the context of the COVID-19 crisis. These do not exhaust the universe of credit enhancements (see Annex II): multilateral development banks have sometimes provided partial guarantees or similar arrangements (such as first loss tranches). There have also been proposals to upgrade the credit status of bonds issued in a restructuring by structuring payment flows so that a payment default to the private creditors would lead to a corresponding default of the relevant international financial institution or another de facto preferred creditor.<sup>9</sup> However, enhancements of this type are not relevant to Fund-financed DDSROs, which always involve providing financing to the member with the understanding that a portion of the financing will be used to enhance a debt restructuring offer, rather than contracts or special purpose vehicles through which private creditor risk is reduced directly.<sup>10</sup>

### Credit Enhancements: Cash and Collateral

11. **Cash and collateral are alternative instruments to lower the risk of the securities bundle that is offered to creditors in a debt restructuring.** Both approaches require upfront cash: directly, as part of the securities bundle, or indirectly, to purchase collateral that can be used to reduce the risk of payments promised to creditors. Cash (or a cash equivalent, like high-quality short-term debt obligations of a third party) can be used in many ways: to pay down outstanding principal, to reimburse unpaid interest, or to pay participation fees to the creditors joining the restructuring. Collateral can consist of high-quality securities (e.g. advanced economy sovereign bonds, or multilateral development bank securities). Depending on the nature of the transaction, the

<sup>9</sup>Bonds issued in the 2012 Greek debt exchange benefit from such a “cofinancing” arrangement ([Zettelmeyer et al 2013](#)). Arrangements of this type have remained rare, however, reflecting well-founded concerns that they could erode the informal consensus (in debt markets, and on the side of official bilateral creditors) supporting the de-facto preferred creditor status (PCS) of relevant international financial institutions. In particular, the World Bank will not engage in PCS sharing.

<sup>10</sup>Under the Articles of Agreement, the Fund lacks the authority to issue guarantees of sovereign bonds backed by the General Resources Account (GRA) (see [The Fund’s Mandate—Future Financing Role: The Current Lending Toolkit and Innovative Reform Options](#), Sup. 1). Any such guarantee would need to consider another financial backing, such as contributor resources administered by the Fund (such as under a trust fund), set up under the authority of Article V, Section 2(b). Any such operations would need to be structured to be consistent with the purposes of the Fund and cannot expose the Fund to any risk of losses. Beyond the legal issues, there are a number of important operational issues that would need to be addressed, including the sources of the funding.

collateral could be held by the creditor or by a third-party in escrow and released to the creditor if the debtor defaults on collateralized obligations. While cash and collateral are both risk free, collateral arrangements can have the disadvantage of complexity. Recent examples for the use of cash or collateral include the 2010 Seychelles and the 2012 Greece debt restructurings (Box 1).

### Box 1. Use of Sweeteners in Greece (2012) and Seychelles (2010)<sup>1</sup>

The Greek debt restructuring of 2012 achieved large debt relief (over 60 percent in net present value terms) with limited coerciveness. One reason for this was the use of an act of parliament to “retrofit” a class voting mechanism on all bonds issued under Greek law (over 90 percent of outstanding), which allowed a change in payment terms if holders of two-thirds (by value) of those instruments voted to accept the restructuring. To reach that participation level, Greece offered several contractual and financial “carrots”, the most important of which was an unusually high cash-like pay-out. Creditors received more than 15 percent of the value of their old bonds in short-term EFSF bonds, representing the largest cash-like sweetener ever in a sovereign debt restructuring. One reason for this generous use of “sweeteners” may have been that Greece, and the European institutions that backed it and provided the financing for the restructuring, wanted to emphasize the “voluntary” character of the restructuring, and hence largely eschewed the use of overt or implicit default threats.

The Seychelles debt restructuring of 2010 also achieved deep debt relief (over 50 percent in net present value terms). A formal exchange offer launched to commercial bondholders in February 2010 had the support of the AfDB in the form of a Policy-Based Guarantee Operation (approved in December 2009). Seychelles proposed to bondholders the provision of a partial guarantee on interest payments from the AfDB—the first time a guarantee from a multilateral institution had been offered in a sovereign debt restructuring. In addition, a principal reinstatement clause was included in the new bonds. Both features played a role in achieving sufficiently high participation in the exchange to trigger a collective action clause, leading to 100 percent participation *ex post*. In addition to raising the value of the offer for investors, the participation of a multilateral agency in the restructuring may have contributed to the success of the offer by convincing creditors that an improved financial offer from Seychelles would not be forthcoming.

<sup>1</sup>This box is based on Zettelmeyer et al (2013), Jahan (2013) and Buchheit et al (2019).

**12. Cash or collateral can raise the value of an offer from the perspective of creditors for a given level of debt relief, increase debt relief for a given value of the offer, or a combination of both.** From the perspective of the debtor, they can hence serve two purposes.

- **First, to make the offer more attractive,** when alternative means to incentivize investor participation—including promising higher face value or coupon payments, more attractive contract terms for participating creditors, or indeed “sticks” including threats of non-payment—are regarded as either unfeasible or undesirable. For example, the debtor’s ability to make the offer more attractive by offering higher principal or interest may be constrained by its future debt service capacity. At the same time, its bargaining power *vis-à-vis* creditors may be constrained by reputational concerns, political considerations, or debt contracts (for example, debt may be collateralized, or bonds lack CACs or have series-by-series CACs, which could give

some creditors significant bargaining power). In such situations, offering cash, collateral or other enhancements may be viewed as the best (or even only) route to securing high participation.<sup>11</sup>

- **Second, to maximize debt relief conditional on securing a minimum level of investor participation.** This can make sense if creditors are more pessimistic about the debtor's prospects than the debtor itself, which implies that the debt burden of new bonds offered, from the perspective of the debtor, will exceed their value from the perspective of the creditor. In this case, it is optimal for the debtor to offer a portion of the offer in cash rather than bonds, up to the point when the opportunity cost of spending the cash on debt relief (rather than, for example, backstopping the debtor's financial system) is equal to its benefit in terms of reducing the future debt burden (Box 2).

### 13. When creditors are heterogenous in terms of preferences or bargaining power, cash or collateral could either be targeted to specific creditor groups or offered as part of a menu.

Creditors may attach different values to the instruments that are offered in a debt exchange, and be willing to pay a premium (in the form of agreeing to more debt relief) for some features. For example, some creditors may have a strong preference for liquid or short-dated instruments. Creditor may also differ with respect to their views about future repayment prospects, which implies that some will value longer-dated bonds less than others. Finally, some creditors could have much stronger enforcement options than others, including because they hold collateralized debt instruments. Cash or collateral could be offered either in a targeted way to bring these creditors on board, or as a part of a menu which allows creditors to choose between bundles that contain cash or collateral and uncollateralized bonds in varying proportions, but deliver roughly comparable debt relief.<sup>12</sup>

**14. Some private creditors and sovereign debt advisors see official CEs as one of many elements that could be conducive to a successful restructuring, but also one whose marginal contribution is difficult to value.** Recent discussions with creditors suggest that they find it difficult to price or assess the value of a credit enhancement provided by multilateral institutions, given the complexity of restructurings and the interplay between the various elements, as well as the lack of a clear path for the debtor country's recovery.<sup>13</sup> By contrast, IFI-supported reform programs are always viewed as critical, since they provide assurances of restoring debt sustainability and of the country's commitment to a program of reform.

<sup>11</sup>Suppose creditors participate only if the sum of the discounted value of bonds  $B$  and cash  $C$  exceed a reservation value:  $\frac{B}{1+r} + C \geq V$ .  $V$  is determined by creditor bargaining power; for example, it is higher if the debtor believes that an aggressive restructuring strategy will hurt its reputation, or if creditors have promising avenues for legal enforcement. The maximum value of  $\frac{B}{1+r}$ , on the other hand, could be constrained by what the debtor can credibly promise to repay. While the debtor can in principle promise a higher  $B$ , the creditor may discount these promises at increasing rates, so that  $\lim_{B \rightarrow \infty} \frac{B}{1+r(B)}$  is a fixed value. If  $\lim_{B \rightarrow \infty} \frac{B}{1+r(B)} < V$ , offering cash or collateral is the only option to meet the creditor's participation constraint.

<sup>12</sup>Alternatively, it may be possible to design an auction to allocate various instruments efficiently across creditors with different preferences. See Willems et al (2021).

<sup>13</sup>See [Cohen et al \(2020\)](#).

**Box 2. When to Offer Cash to Raise Debt Relief**

Suppose a debtor can offer two instruments in exchange for old debt: cash,  $C$ , or new bonds,  $B$ . Creditors discount the value of the bonds at an interest rate  $r$ , which is incorporates a risk premium. To get creditor to accept the debt exchange offer, the debtor’s offer must exceed minimum value  $V$ :  $\frac{B}{1+r} + C \geq V$ .

The debtor must take any cash it uses in the offer from its reserves,  $R$ . The utility of the remaining reserves to the debtor is represented by the function,  $U(R - C)$ , where  $U' \geq 1$  and  $U'' < 0$ . The assumption that  $U' \geq 1$  reflects the fact that the utility of a unit of reserves must be at least as great as its dollar value. It can be larger than its dollar value because of the option value of future use of reserves for an essential purpose, such as safeguarding financial stability. The concavity of the function ( $U'' < 0$ ) captures the assumption that the opportunity costs of using a unit of reserves to repay creditors rises for a very low level of reserves.

The debtor maximizes an objective function that considers both the value of keeping an adequate value of reserves and the value of using cash to make the exchange offer attractive to creditors, so that the offer is accepted. Specifically, the debtor maximizes  $U(R - C) - \frac{B}{1+d}$  subject to  $\frac{B}{1+r} + C = V$ , where  $d \geq 0$  denotes the discount rate of the debtor, and  $\frac{B}{1+d}$  is the present value debt burden from the perspective of the debtor.

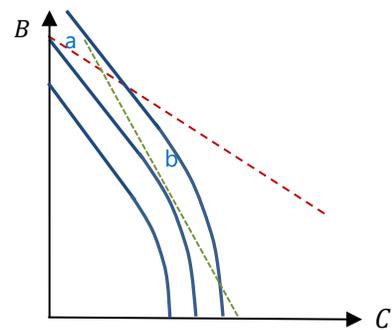
Substituting the constraint into the objective function, this is the same as saying that the debtor chooses the cash level to maximize  $U(R - C) - \frac{1+r}{1+d}(V - C)$ . It does so by comparing the utility of keeping a unit of cash in reserves, given by  $U'(R - C)$  with the impact on the debt burden of offering that unit of cash to creditors in exchange for having to issue fewer bonds. That impact is given by the factor  $\frac{1+r}{1+d}$ , which in turn depends on the relationship between the discount rates of the debtor and the creditors. Depending on that, there can be two situations:

- a. If the debtor and creditors have the same discount rate, or if the debtor discount rate is higher than the creditors, then  $\frac{1+r}{1+d} \leq 1$ . In that case, it does not make sense to use any cash in the restructuring, because a unit of cash spent in the restructuring will lower the present value of debt by less than one unit. However, by assumption, the utility of keeping cash in reserves, which is the opportunity cost of using cash in the restructuring, is always at least one unit ( $U' \geq 1$ ).
- b. If the creditors have a higher discount rate than the debtor, then  $\frac{1+r}{1+d} > 1$ . In that case, it makes sense for the debtor to spend cash in the restructuring until:

$$U'(R - C^*) = \frac{1+r}{1+d}$$

The left-hand side expression denotes the cost of reducing the debtor’s reserves by one unit. The right-hand side denotes the reduction in the debt burden achieved by dedicating an extra unit of reserves to the debt exchange offer. The optimal cash sweetener,  $C^*$  is set to equalize these marginal costs and benefits. The higher the discount rate of creditors relative that of the debtor, the higher the optimal cash sweetener  $C^*$ .

The figure to the right illustrates the argument. The blue lines represent “indifference curves” between offering bonds and cash. For low levels of  $C$ , reserves are high and the slope of the curves (the marginal rate of substitution between  $B$  and  $C$ ) is constant, namely,  $-(1 + d)$ . For larger  $C$ , the curves become concave, as the debtor requires progressively lower levels of  $B$  to justify greater use of cash. The dotted/shaded lines represent the participation constraint of creditors, with slope  $-(1 + r)$ . The optimal restructuring offer  $B$  and  $C$  is given by the intersection of the indifference curve with the participation constraint that is closest to the origin. For  $r < d$  this is a point on the vertical axis ( $C = 0$ , point **a**). For  $r > d$ , it is given by the tangential point **b**.



**15. Even where there is a rationale for the use of cash or collateral in a debt exchange offer, it does not necessarily follow that this should be supported by IMF financing.** For the reasons outlined in paragraphs 12-13, a debtor may want to resort to cash or collateral

“sweeteners”. When it lacks the liquid funds to finance this, it may turn to the Fund.<sup>14</sup> Before deciding whether to provide such financing, however, the Fund must confirm that the proposed restructuring approach is indeed superior to alternative strategies that do not involve cash or collateral. Offering sweeteners may not be the only way to raise debtor participation. To the extent that the perceived need to offer such sweeteners is linked to weak bargaining power or low credibility of debtor policies, such constraints may be influenced by a Fund arrangement even when Fund financing is used only for conventional balance of payments support rather than to offer sweeteners. Furthermore, the frontloading of resources needed to finance the operation must not undermine the credibility of the member’s policy adjustment (relative to a phased disbursement conditional on successfully completing the program reviews).

**16. Fund financing for DDSROs should not be so large as to result in a debt stock that is dominated by financing from the Fund and other multilaterals.** From the perspective of resolving the member’s medium-term balance of payments problem, a large Fund-financed DDSRO has two effects. Deeper and more comprehensive debt restructuring should strengthen the debtor’s capacity to repay, and hence reduce future borrowing costs. But the effect of owing a much larger share of public debt to a de-facto preferred lender may run in the opposite direction, particularly if the IMF-financed operation does not definitively resolve concerns about future debt sustainability. Replacing non-multilateral debt with Fund financing where debt sustainability is not assured would raise future borrowing costs, complicate market access, and increase risks to the member’s ability to repay the Fund, as there would no longer be a stock of non-multilateral debt sufficiently large to absorb losses. For these reasons, there may be a limit on the extent to which the Fund can support DDSROs in specific cases. Where this limit lies and whether it is binding will need to be assessed case by case. In particular, it will be higher (in the sense of allowing larger Fund financing of DDSROs) in restructurings that restore debt sustainability with high probability than in restructurings that restore debt sustainability, but not necessarily with high probability.

### Market-Based Buybacks

**17. Market-based buybacks offer a path to debt reduction without any need to negotiate with creditors.** When debt trades at a steep discount to face value, repurchasing bonds in the secondary market allows the issuer to reduce the face value of the debt at a fraction of the cost of paying down. For example, in a 1988 buyback that drew widespread attention, Bolivia used \$34 million in donated funds to buy back almost half of its outstanding debt to commercial creditors—\$308 million out of \$670 million—at a price of just 11 cents on the dollar. Since market-based buybacks are voluntary transactions, they do not require negotiations with creditors (although the offer could be made contingent on prices and on meeting a minimum participation threshold). Hence, unlike distressed debt exchange offers, they do not trigger reputational costs or ratings

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<sup>14</sup>Because of the Fund’s de-facto preferred creditor status, borrowing cash from the Fund may reduce the value of new bonds in the eyes of creditors. However, because the probability that the country cannot repay both the Fund and creditors is less than 1, the value of IMF-financed cash will always exceed this reduction in the value of bonds.

downgrades (at least not over and above the reputational costs or downgrades that the debtor might have suffered by falling into distress).

**18. At the same time, buybacks tend to raise the price of debt in the secondary market and consume scarce debtor or donor resources.** Suppose that a distressed debtor were to attempt to buy back its entire debt stock through the secondary market, without setting any reservation price. This is equivalent to an attempt to repay early and in full. The price should hence rise to the face value of the debt. The buyback would end up costing the same as full repayment, and a donor-funded buyback would have constituted a pure transfer from donors to creditors. Indeed, to the extent that the market price rises as a result of the buyback, even a partial buyback constitutes a transfer to creditors. For example, in the case of the Bolivian buyback, the secondary market price of debt almost doubled as a result of the buyback, from 6 to 11 cents on the dollar. The debtholders hence became richer by  $0.05 \times 670 = 33.5$  million—almost equal to the amount that had been donated to benefit Bolivia.

**19. In an influential paper, Bulow and Rogoff (1988) argued that, for this reason, buybacks financed by debtor cash would generally make debtors worse off.** The argument was premised on the assumption that buybacks do not lead to an efficiency gain (as may be the case, for example, if defaults and negotiated debt restructurings have economic costs). In this case, the effect of a buyback is purely redistributive: any gain by creditors—reflected in an increase in the market price of debt—must come at the expense of the debtor. Conversely, any gain by debtors must come at the expense of creditors, reflected in a decrease in the market price. Bulow and Rogoff argued that when a buyback is financed by cash, it is generally the debtor that loses. By buying back debt, the debtor gives up cash with certainty. In exchange, it gains a reduction in debt service, but it benefits from this reduction only in futures states in which it would have repaid in full. Since the probability of full repayment is always smaller than the market price of the debt (as this reflects the probability of full repayment *plus* some value that the creditor expects to recover in default states), the expected reduction of debt service is always less than the cost of the buyback. As a result, the debtor would benefit only if spending cash on a buyback significantly lowers payments to creditors in default or debt restructuring states. Bulow and Rogoff argued that because of limited enforcement of sovereign debt claims, this was unlikely to be the case. The payments that creditors could extract from the debtor in a default were unlikely to be very sensitive to the level of its cash reserves.<sup>15</sup>

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<sup>15</sup>A buyback of cost  $C$  reduces its repayments obligations by  $C/P$  in full repayment states. In all other (default) states, assumed to occur with probability  $\pi$ , it is assumed to reduce transfers to creditors by  $qC$ , where  $q$  is the share of cash that creditors would seize in a default. Hence, a buyback makes sense for the debtor if and only  $\pi q + (1 - \pi)/P > 1$ . We know that  $(1 - \pi)/P < 1$  (as the price  $P$  of a unit of debt does not only reflect the expected repayment in full repayment states,  $1 - \pi$ , but some recovery value in the default state). Hence, for small  $q$ ,  $\pi q + (1 - \pi)/P < 1$ . Note that this argument focuses only on the impact of cash buybacks on solvency. Taking into account liquidity effects—namely, that a cash buyback depletes reserves, whose utility may exceed their dollar value because of the option value of future use for an essential purpose (Box 2)—would further strengthen the argument against cash buybacks.

**20. If buybacks lead to efficiency gains, however, they can benefit both the debtor and the creditors.** Two potential sources for such efficiency gains stand out.

- **First, by improving the debtor’s solvency and/or reducing rollover risk, buybacks can reduce the probability of default and debt restructuring, and hence their expected costs,** which include capital flight, credit squeezes, and output declines.<sup>16</sup> These costs do not benefit creditors; they could hurt creditors by delaying a recovery and return to solvency. The possibility that buybacks help avoid costs of default has long been recognized as one of the reasons why buybacks can be helpful to the debtor.<sup>17</sup> When the counterfactual to buybacks is not default but a pre-emptive debt restructuring, buybacks can lead to efficiency gains by avoiding (or lowering the probability of) lengthy negotiations, the cost of hiring legal advisers, and the reputational cost of a debt exchange regarded as “distressed” by creditors and rating agencies. Note that the reduction in default or restructuring risks could come not only from the solvency impact of the buyback but also from its impact on the repayment profile of the borrower, i.e. the fact that it could reduce rollover risk.
- **Second, there could be gains from trade between debtors and creditors if bonds are underpriced compared to their fundamental value.** One reason for such underpricing could be that creditors have disproportionately negative expectations of the country’s future. In these circumstances, the cash cost of the buyback could be smaller than the expected reduction in debt service from the perspective of the debtor country—namely, when the market price of the debt (based on the creditors’ perception of the probability of avoiding default) is lower than warranted by the debtor’s perception of the probability of avoiding default.<sup>18</sup> Of course, for the buyback to be a good idea, the debtor perception of its probability of success must ultimately prove to be right, which may be the case if they have private information about their ability to repay. A related argument in favor of buybacks is that a buyback can signal the debtor’s private information to the market (for example, intentions to reform), reducing its cost of borrowing if it still has market access, or accelerating market re-access and lowering its cost of borrowing over the medium term if it does not.<sup>19</sup> A further reason for why bonds may be underpriced is illiquid markets, leading investors to charge a liquidity premium. This may be higher in distressed debt markets, as demand shifts to specialized investors.

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<sup>16</sup>Defaults and debt restructurings are associated with lower GDP growth—which can average about 2 percentage points each year—and declines in investment, private sector credit and capital flows (Asonuma et al. 2019). Several channels can lead to lower GDP growth after a debt restructuring including reduced sovereign access to market financing, spillovers on trade, investment, and productivity, and reduced corporate access to foreign credit (Sturzenegger 2004, Borensztein and Panizza 2009). However, output costs are smaller after a preemptive restructuring in which an agreement is reached in a pre-default context (Asonuma and Trebesch 2016). Even post-default, they can be reduced when debtors and creditors are able to reach a quick agreement (Asonuma et al. 2019).

<sup>17</sup>See, among others, Rotemberg (1991), Prokop and Wang (1997), and Hatchondo et al (2019).

<sup>18</sup> $1 - \pi > P$ , where  $1 - \pi$  is the probability of avoiding default from the country’s perspective. This condition is sufficient for the buyback to improve the solvency of the debtor (see footnote 11).

<sup>19</sup>See Acharya and Diwan (1993) and Marchesi (2006).

In circumstances such as these, buybacks can *both* benefit the debtor *and* raise the market price of debt, hence benefiting creditors as well.

**21. Buybacks financed by borrowing from a (de facto) preferred lender will generally benefit the debtor, even when they do not lead to efficiency gains.** A buyback financed by a lender does not consume any cash; instead, it creates a liability. But since this loan is used to buy back a portion of the existing debt, total debt service will decline, so long as the interest rate charged by the (de facto) preferred lender is lower than the secondary market yield. In the event of default, whatever resources are available for creditors will first be used to repay the senior lender and then the original creditors, but this makes no difference from the perspective of the debtor. As a result, a buyback financed by a (de facto) preferred lender always improves the solvency of the debtor, while the original creditors will be worse off (unless there is an efficiency gain, in which case both the debtor and creditors could be better off).<sup>20</sup>

**22. While buybacks financed by Fund lending would be expected to benefit both the debtor and the creditors, the distribution of the gains could depend on exactly how they are financed.** If the level of access is determined prior to the decision on whether or not to buy back debt, and if the member is free *not* to buy back debt after the access level has been set, then the buyback is equivalent to a buyback from the members' own resources. Any downward effect on the market price of debt due to the de-facto subordination of private creditors to IMF lending would have occurred at the time when access was determined. Since the decision to use some of this access to buy back debt does not create an additional liability to the Fund, creditors will view it like a cash buyback funded by the member's own resources. In contrast, if a portion of Fund financing is earmarked to the buyback, the buyback increases the member's liability to the Fund, and the argument of paragraph 21 applies. The practical implication is that the buyback price should be lower if the buyback is financed by earmarked Fund lending than if Fund financing is independent of the buyback. This implies that a buyback financed by earmarked Fund financing will achieve higher debt relief. But it also implies higher market yields, and hence higher future borrowing costs. Depending on the purpose of the buyback, this may mitigate against using earmarked funds.

**23. Even if buybacks are efficiency-enhancing and benefit the member, they may not represent the best use of Fund resources.** Similar caveats apply as outlined in paragraphs 15 and 16 in the context of potential Fund financing of cash or collateral. First, the benefits of supporting buybacks must be weighed against alternative approaches to improving the solvency and/or liquidity of the debtor. When debt is sustainable, this includes a Fund supported program without a buyback. When debt is unsustainable, this includes a negotiated debt restructuring in the context of a Fund-supported program (which may or may not include "sweeteners" such as cash or collateral).

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<sup>20</sup>This argument is sketched in Bulow and Rogoff's original 1988 paper and explored in more detail by Claessens et al (1991), Jeanne (2003), Baglioni (2015), and Hatchondo et al (2017). A possible caveat, not captured in these models, is that although the debtor's solvency improves, the new debt service might be more difficult to refinance in the future, particularly if the buyback retires long-term debt. However, this could only be the case if the repayment profile of the loan from the de facto preferred lender is less favorable (in the sense of being shorter term, or more "bunched") than the repayment profile of the bond that is bought back. Furthermore, if there are efficiency gains associated with the buyback (see below) the post-buyback price will rise and market yields will fall, making debt easier to refinance.

By bringing pressure to bear on creditors, such a restructuring could lead to greater debt relief than market-based buybacks. Second, the volume of non-multilateral debt that remains outstanding in the market after the buyback must be high enough to absorb debt relief that may be required in a possible future restructuring, with the requisite volume depending on whether post-buyback debt is judged to be sustainable with high probability or merely sustainable.

**24. In light of these considerations, a market-based buyback financed by Fund lending to the debtor could be considered under narrow conditions, namely:**

- i. In a pre-default setting, AND
- ii. When the reduction in debt service commitment achieved by a buyback of the size that the Fund could finance within the constraints described in the previous paragraph is expected to help prevent a debt restructuring or default. This would be the case if post-buyback debt is expected to be sustainable; and
  - the buyback is expected to meaningfully reduce debt vulnerabilities.<sup>21</sup> For example, this might be the case if the buyback focuses on a bond series that contributes to an unfavorable repayment profile, reducing rollover risk; or if the debt burden is “borderline sustainable” prior to the buyback, and the buyback contributes to pulling it into sustainable territory; or
  - the buyback meaningfully reduces the debt burden. This would be the case if the market price of the member’s debt is sufficiently low, even in the face of a Fund-supported adjustment and reform program, that a modestly-sized buyback can achieve a substantial reduction in nominal debt obligations.

Condition i. will generally be necessary because when the costs of default have already been sunk, the added reputational costs of “cleaning up” the default through a negotiation rather than a buyback would generally appear to be small.<sup>22</sup> Condition ii. is also necessary because in its absence, the buyback would be dominated either by a negotiated debt restructuring (if post-buyback debt is not expected to be sustainable) or by a Fund-supported program without any debt operation (if post-buyback debt is expected to be sustainable and the buyback does not meaningfully reduce debt vulnerabilities or the debt burden).

**25. Although Fund-supported buybacks could help reduce debt vulnerabilities or the debt burden, they are unlikely to be powerful enough to address an unsustainable debt problem.**

Even when buybacks deliver substantial debt relief per unit of debt bought back (see next section), the volume of buybacks that the Fund could plausibly finance within the constraints laid out in

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<sup>21</sup>In this context, “meaningful” refers to an expected reduction of debt vulnerabilities or the debt burden that exceeds the opportunity cost of using the cash for other purposes, such as shoring up reserves, or supporting higher domestic consumption or investment.

<sup>22</sup>While paragraph 18 offers a second potential efficiency argument for a buyback, namely, gains from trade when creditors have higher risk perceptions than the debtor, these gains from trade could also be realized in a negotiated debt restructuring, by offering short-dated instruments, cash or collateral.

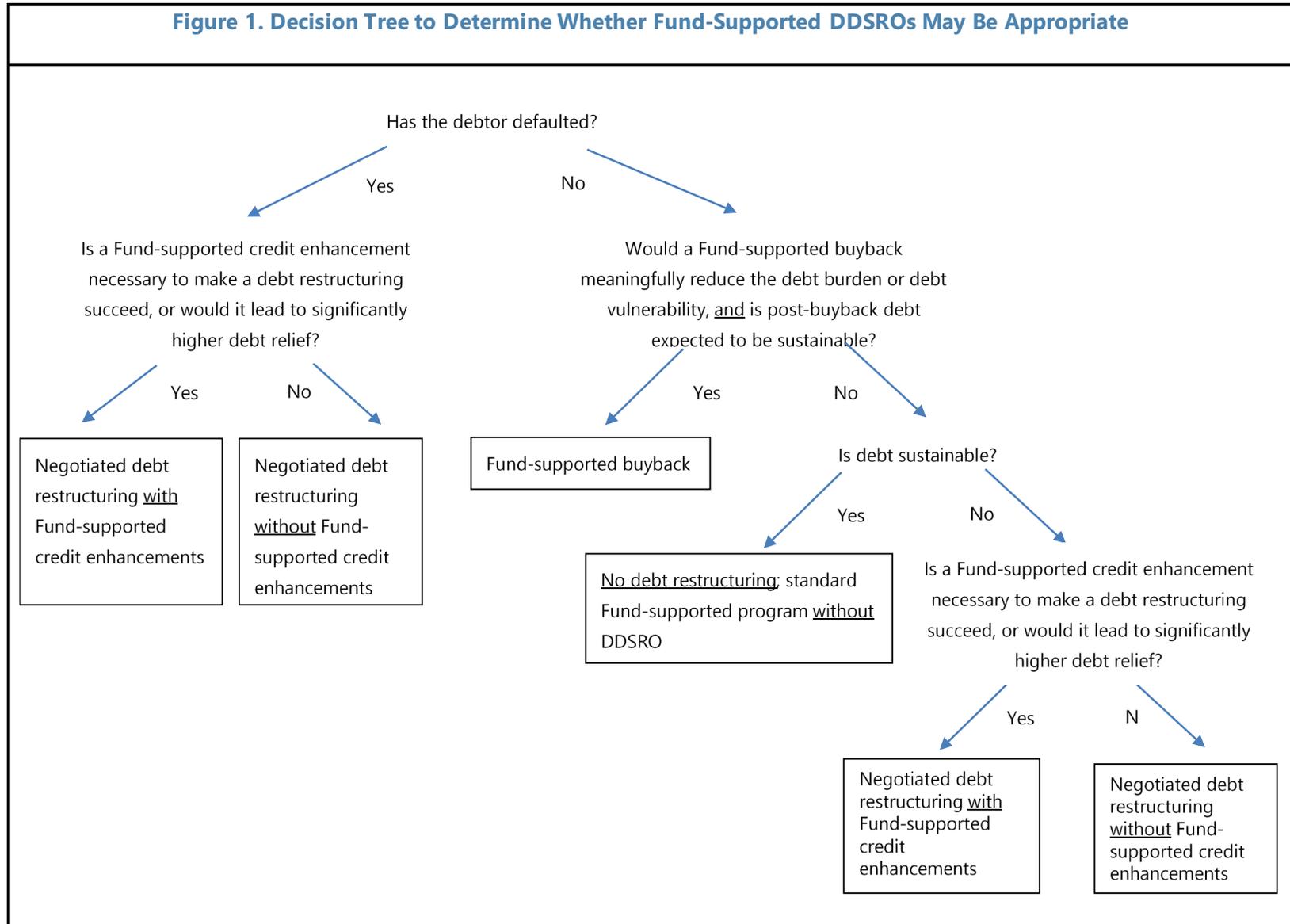
paragraphs 16 and 23 will generally be too small to produce a large reduction in the net present value of the public debt. As a result, buybacks will be useful mainly in countries in which sovereign risk is perceived to be high but debt is sustainable, or in countries in which it is “borderline” unsustainable. In the former, they could be part of a package of policy measures to reduce the risk of a debt crisis. In the latter, they could help restore sustainability in conjunction with a very strong and credible adjustment and reform plan. Deeper debt sustainability problems will require negotiated debt restructurings. While such restructurings could, in some circumstance, benefit from a cash or collateral sweetener (paragraph 15), the latter is only one of several instruments that can be deployed to make such restructurings effective. Hence, the availability of financing to support DDSROs does not constrain the debt relief that can be achieved in a negotiated restructuring in the same way that it constrains a buyback operation.

**26. Figure 1 presents a decision tree that summarizes the conditions under which Fund-supported DDSROs might be appropriate.**<sup>23</sup> The decision tree summarizes and combines the conditions outlined in paragraphs 12, 15, 20 and 23. There are four policy outcomes, described in the bordered text boxes, which should all be interpreted as occurring in the context of a Fund-supported program: (1) a Fund-supported buyback; (2) a negotiated debt restructuring with Fund-supported credit enhancements (cash sweeteners or collateral); (3) a negotiated debt restructuring without Fund-supported credit enhancements; and (4) a standard Fund-supported program without any debt restructuring or buyback. Which of these policy outcomes makes most sense will depend on whether the debtor has defaulted or not, whether it’s debt is sustainable or unsustainable (and if it is unsustainable, whether it remains unsustainable after the buyback), and on whether the conditions under which buybacks and Fund-supported credit enhancements can make a difference (as described in paragraphs 20 and 23).

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<sup>23</sup>This decision tree is intended to assist staff and members in considering the benefits of Fund-supported DDSROs in different scenarios and is not intended as a binding framework or as a new policy. It considers only *whether* DDSRO support might be appropriate but does not speak to the size of the potential DDSRO operation.

**Figure 1. Decision Tree to Determine Whether Fund-Supported DDSROs May Be Appropriate**



## FUND EXPERIENCE WITH THE DDSR POLICY

**27. The Fund's DDSR policy was created in 1989 to support the implementation of the Brady Plan (Box 3).** In March 1989, US Treasury Secretary Nicholas F. Brady launched the Brady Plan, that would allow countries to exchange defaulted commercial bank loans, which had begun to trade in secondary markets, for bonds backed by US treasuries. The Fund and the World Bank were called to use their resources to finance, guarantee, and/or finance the provision of collateral for DDSROs between their members and commercial banks (see Box 4 for the World Bank's approach). This contrasted with the Fund's traditional approach of providing support for a member's general balance of payment needs without specifically earmarking funds. The Fund's idea was to provide new incentives for private creditors to participate in the debt restructurings by signaling strong official support for these operations and thereby helping to catalyze participation, foster debt reduction,<sup>24</sup> and simultaneously strengthen prospects for greater creditworthiness and restore voluntary private financing for the debtor/member in the future.<sup>25</sup>

**28. The Fund's DDSR support was mainly used to finance members' debt buybacks and collateralization of principal and interest.** Set-aside resources were available to finance debt (principal) reduction in the form of buybacks and principal and interest collateral on the discount bond exchanges. Their availability was generally phased in line with reviews under Fund-supported programs. Augmentations were available for interest support, including to finance interest collateral for both discount bond and reduced interest par bond exchanges and to collateralize principal in reduced interest par bond exchanges.<sup>26</sup> The Board could approve augmentations on a case-by-case basis, where such support would be decisive in facilitating further cost-effective operations and catalyzing other resources, consistent with significant further progress toward external viability. Although access was determined on a case-by-case basis, set-asides generally involved 25 percent of access under the Fund-supported program, and augmentations were up to 40 percent of the member's quota. The DDSR policy fell into disuse in the late 1990s and was discontinued by the Board in 2000. A further description of the Fund's earlier DDSR policy is provided in Annex I.

<sup>24</sup>See Fund Support for Debt Reduction Operations – Preliminary Considerations, EBS/89/78 (04/19, 1989), page 3.

<sup>25</sup>[Remarks by Secretary Brady to the Brookings Institution and The Bretton Woods Committee Conference on Third World Debt on March 10, 1989](#) (noting that up until early 1989, the Fund's discussion of its support for DDSROs was still focused on its continuing role to provide policy advice and traditional, general BoP support under Fund arrangements, which could be designed to help free resources in a debtor country for use to cover market-based debt reduction operations; see [Issues in Managing Debt Situation](#), (02/24/1989), pages 7-8). The US proposal was endorsed by the Interim Committee in Spring Meetings in April 1989, which called for the Fund to "provide resources in appropriate amounts to members to facilitate debt-reduction operations for countries undertaking such sound economic reforms, by setting aside a portion of members' purchases under Fund-supported arrangements". See the 1989 IMF Annual Report.

<sup>26</sup>See [Summing Up by the Chairman – Fund Involvement in the Debt Strategy](#); [Management of Debt Situation](#), page 16; and [Modalities of Fund Support for Debt and Debt-Service Reduction](#), , Sup. 3 (06/05/1992).

### Box 3. The Economic and Political Context of the 1989 DDSR Policy

**The DDSR and Brady Plan emerged out of the 1980s Debt Crisis with developing economies facing severe economic stress due to a combination of exogenous shocks and policy choices.** Initially, the Fund took a “concerted lending” approach to help, providing countries additional financing conditional on countries reaching agreements on debt rescheduling and new financing with commercial banks.<sup>1</sup> While this helped countries buy time to implement adjustment programs and helped avoid a systemic crisis, it could not alleviate the overall debt overhang. Over time, heavy debt burdens continued to discourage new foreign investment and the retention of domestic savings, wiping out prospects for dealing with the debt crisis through economic growth. Meanwhile, commercial banks were reducing their exposure to these economies and setting aside large provisions to cover sovereign debt losses, making it easier to exit and the prospects for generating new financing more challenging.

**The Brady Plan, introduced in 1989, represented the culmination of an evolution in views on debt relief.** In the early stages of the crisis, efforts to provide deeper debt relief faced opposition from some creditors and even within the Fund. In the U.S. there were concerns about the political ramifications of the perception that taxpayer money was being used to bail out foreign creditors and commercial banks. Some commercial creditors argued that debt relief would fail to address underlying issues, depending more on debtor country adjustment than anything else. In the Fund, some argued that debt relief would delay the normalization of debtor-creditor relations. As the need for a new debt strategy became more pressing, the Brady Plan introduced by the U.S. Treasury Secretary in 1989 aimed debt overhang problem once and for all, marking a shift in the U.S. position on debt relief. It was premised on the idea that meaningful debt relief could and should be provided by commercial banks on a voluntary basis.<sup>2</sup>

**The Fund’s DDSR Policy was the result of a protracted negotiation (see also Annex I).** Up until early 1989, Fund support for DDSROs was still limited to its traditional role of providing general BoP support, with reserve targets set such that reserves could support members’ DDSROs. During the Board meetings leading up to the establishment of the DDSR Policy, “a number of Directors advised great caution, and a few questioned the appropriateness of direct support by the Fund, in financing debt reduction operations.”<sup>3</sup> A hard-fought compromise, including as to the amount of financing that could be earmarked and the interaction with the Fund’s access limits policy, was memorialized in the DDSR policy.

<sup>1</sup>Boughton (2001).

<sup>2</sup>Proponents of voluntary debt reduction at the time argued that if creditors voluntarily reduced the face value of debts, this would promote adjustment, resulting in a greater capacity to service debt to compensate for initial losses (Helpman (1989)).

<sup>3</sup>See [Concluding Remarks by the Chairman Issues in Managing the Debt Situation](#) - (3/17/89). At these meetings, some Directors also suggested that the Fund provide general BoP financing to help a member to reconstitute its reserves after it finances debt or debt-service reduction operations, as an alternative to earmarking Fund financing directly to support these operations.

#### Box 4. The World Bank's Approach

In parallel with the Fund's DDSR policy, with the advent of the Special Program of Assistance (SPA) for low-income, debt-distressed countries in Sub-Saharan Africa (1987) and the unveiling of the Brady Plan (1989), the World Bank support in the helping reduce the burden of external commercial debt evolved along two tracks: (i) policy-based loans and guarantees to support DDSROs and (ii) the setting up of the Debt Reduction Facility for IDA-only Countries.

##### Policy-based Loans and Guarantees

The Executive Board of the Bank agreed to provide funds for voluntary debt reduction schemes thereby giving rise to the Bank's policy-based financing (DPOs) for DDSR. As part of the Brady Plan, the Bank provided financing to Argentina, Bulgaria, Cote d'Ivoire, Ecuador, Mexico, Panama, Peru, Poland, Philippines, Venezuela and Uruguay.<sup>2</sup> Following case-by-case analysis, and on an exceptional basis, the Bank approved certain limited or partial waivers of the negative pledge clause in connection with the issuance of collateralized Brady bonds. Since their inception in the context of the Brady Plan, DDSR policy-based instruments and later on guarantees have evolved into one of the options available to Bank borrowers to assist them in reducing commercial debt servicing costs to a manageable level, as part of a medium-term financing plan in support of sustainable growth.

##### The Debt Reduction Facility for IDA-only Countries

The Boards of the International Bank for Reconstruction and Development (IBRD) and IDA established the World Bank's Debt Reduction Facility (DRF) for IDA-only countries in 1989. The DRF provides grant funding to help eligible countries with a strong reform program and high public debt reduce their external commercial debt as part of a comprehensive debt reduction program. This was achieved primarily through buying back sovereign debts owed to external commercial creditors at a deep discount. DRF grant support could also be used to pay the fees of legal and financial advisors hired by the debtor government to prepare for a buy-back operation. Overall, the DRF supported 25 buy-back operations in 21 IDA-only countries, extinguishing about US\$10.3 billion of external commercial debt principal and associated interest arrears and penalties.<sup>1</sup>

The DRF was originally available solely to IDA-only eligible countries that met certain other conditions tied to economic performance under a medium-term adjustment program and the implementation of a satisfactory debt management strategy. While the DRF predated the Heavily Indebted Poor Countries (HIPC) Initiative, beginning in 2004, DRF country and debt eligibility criteria were aligned with the HIPC Initiative and it was expected that operations supported by the DRF should ensure at a minimum full delivery of HIPC debt relief.

In November 2020, the World Bank's Executive Board approved the extension of the DRF mandate to end-June 2023 and also approved an expansion of its scope to position the facility to better meet the needs of IDA countries given the current commercial debt landscape.

<sup>1</sup>World Bank website on debt relief: <https://www.worldbank.org/en/topic/debt-relief>

**30. Consideration of the use of Fund support for DDSROs in 1980s-90s was guided by three elements:**<sup>27</sup> (i) the strength of economic policies pursued by the member; (ii) the scope for a voluntary, market-based debt reduction operation that would help the member regain access to credit markets and the return to external viability with growth; and (iii) an assessment that the operation represented an efficient use of scarce resources.

**31. Fund-support for DDSROs in the form of set-asides or augmentations was used in 11 operations in 10 countries over 1989-98** (Table 1).<sup>28</sup> As was standard in Brady-deals, debt

<sup>27</sup>See *Summing Up by the Chairman – Fund Involvement in the Debt Strategy*.

<sup>28</sup>Philippines 1989 & 1993, Mexico 1990, Venezuela 1991, Argentina 1992, Poland 1994, Ecuador 1994, Bulgaria 1994, Panama 1996, Peru 1997, Cote d'Ivoire 1998.

reduction was achieved via a menu of options to creditors, including through buybacks, discount exchanges, and par bonds. Out of the 11 operations carried out with Fund financial support, seven involved buybacks, and all but one involved a discount exchange. For the cases where data are available,<sup>29</sup> the Fund contributed with, on average, 22 percent of the total “cost” (financing) of the DDSRO. These costs were related to guarantees for principal and interest collateral, and cash down payments for buybacks. Fund support for DDSROs was part of a package of official financing that included World Bank support in the form of either policy-based financing for DDSR or DRF financing (Box 4).

**Table 1. Debt and Debt-Service Operations Involving Fund-Support**

Country	Year	Total debt re-structured <sup>1</sup>	DDSR Cost <sup>2</sup>	Fund Contribution to cost	Modalities of Restructuring Package				
					Buyback	Discount exchange	Principal collateralized par bonds	Other bonds	Pre-payments through collateralization
Philippines	1989	1.3	0.7	0.1	X				
Mexico	1990	48.2	7.1	1.3		X	X		X
Venezuela	1991	19.7	2.6	0.9	X	X	X	X	X
Argentina	1992	19.4	3.1	1.0		X	X		X
Philippines	1993	4.5	1.1	0.2	X		X	X	X
Poland	1994	10.0	1.9	0.3	X	X	X	X	X
Ecuador	1994	4.5	0.6	0.1		x	X		X
Bulgaria	1994	6.2	0.7	0.1	X	X		X	X
Panama	1996	1.9	0.1	0.0			X	X	X
Peru	1997	10.6	1.4	0.2	X	X	X		
Côte d'Ivoire	1998	n.a.	0.2	0.1	X	X	X		

Sources: [Use of ESAF Resources for Commercial Debt and Debt Service Operations- Further Considerations](#) (EBS/97/94); [Peru-Selected Issues](#) (SM/98/108); [Côte d'Ivoire-Final Document on the Initiative for Heavily Indebted Poor Countries](#) (EBS/98/40).

1/ In US\$ bn. Excludes past due interest. Includes debt restructured under new money options for Mexico, Venezuela, the Philippines, Poland, Panama.

2/ In US\$ bn. Cash used for buy-back (i.e., market value of debt bought back) plus cost of purchasing collateral. Cost based on the time of the operations closing and, for Venezuela resources used to provide comparable collateral for bonds issued prior to 1990.

**32. A closer examination of these cases suggests that Fund-financed buybacks offered substantial debt relief per unit bought back.** Table 2 shows the volumes bought back as well as the buyback price (secondary market price at the time of the agreement in principle, when buybacks were announced).<sup>30</sup> The debt relief per face value unit bought back is 1 minus the buyback price. This can be compared to the debt relief per restructured face value of the entire debt restructuring,

<sup>29</sup>Information on DDSR has been obtained through a range of Fund documents including Board DDSR policy papers, country reports, and annual reports on *Private Market Financing for Developing Countries*. For two cases (Peru and Côte d'Ivoire) detailed information on the DDSR structure was not found.

<sup>30</sup>For four of the five countries with Fund-supported buyback operations, secondary market prices at the time of the agreement in principle (AIP) are very close to the *implied price* calculated by dividing the approximate cost of the buyback operation by the debt relief achieved with it. The only country where this was not true was Venezuela, as we could not disentangle buyback costs from costs related to some additional collateral to other operations.

including both buyback and debt exchange. The table presents two independent estimates for this debt relief: one derived from data reported in contemporaneous IMF documents (column H, see note 5 to the table) and another recomputed using bond-by-bond data (column I, see note 6).<sup>31</sup> The two estimates are generally close. The average net debt relief per face value unit bought back (weighted by face value) was 59 percent. This is substantially larger than the weighted average debt relief per face value unit restructured in the entire operation, which was 30 percent based on the debt relief estimates reported in column H, and 25 percent based on the estimates reported in column I.

**33. However, the buyback component of Fund-supported DDSROs—and hence the contribution of buybacks to total debt relief—was small, averaging US\$0.8 billion, or 26 percent of the total DDSR size.**<sup>32</sup> This is similar to the 2012 Greek restructuring, in which the scale of a buyback operation conducted in December 2012 was also small relative to the total volume of the restructuring,<sup>33</sup> but achieved relatively high debt relief as a percentage of both face value and present value of the bonds bought back, in the order of 65 percent.<sup>34</sup> In comparison, the February-May 2012 Greek debt exchange achieved present value debt relief of 57 percent, using the same discount rate.

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<sup>31</sup>We are very grateful to Christoph Trebesch of the Kiel Institute for the World Economy for making the underlying bond data available to us.

<sup>32</sup>Considering only the cases with buybacks, the average size of Fund-supported buyback operations was US\$1.4 billion (in terms of face value) or 48 percent of the total DDSR size.

<sup>33</sup>Under the buyback, €11.3 billion in EFSF financing was used to retire €31.9 billion of Greek bonds, hence reducing the face value of Greece's debt by €20.6 billion. By comparison the debt exchange totaled €200 billion.

<sup>34</sup>In face value terms, the debt relief was  $€31.9 - €11.3 = €20.6$  billion Euros. In present value terms, the debt relief was €20.6 billion when evaluated at a 3.5 percent discount rate, and €17.1 billion when evaluated at a 5 percent discount rate. This must be compared either to the face value of the bonds bought back (€31.9) or their present value, namely, €31.7 when evaluated at a 3.5 percent discount rate, or €25.4 billion when evaluated at a 5 percent discount rate. See Zettelmeyer et al (2013) for details.

Table 2. Cost and Debt Relief of Debt and Debt-Service Operations Involving Fund Support<sup>1</sup>

Country	Year	DDSR Cost				Buyback			Entire restructuring			
		Total debt re-structured <sup>2</sup>	Total Cost <sup>3</sup>	Market value of buyback	Cash cost of collateral	Buyback price	Face value bought back <sup>4</sup>	Debt relief per face value unit bought back	Debt relief per face value unit restructured <sup>5</sup>	Debt relief per face value unit restructured <sup>6</sup>	Estimated haircut from investor perspective <sup>7</sup>	Buyback equivalent price, BEP
		A	B	C	D	E	F=C/E	G=1-E	H	I	J	K=B/(H*A+B)
Philippines	1989	2.8	0.7	0.7	0.0	0.50	1.3	0.50	0.24	0.24	0.46	0.50
Mexico	1990	48.2	7.1	n.a.	7.2	n.a.	0.0	n.a.	0.28	0.24	0.44	0.35
Venezuela	1991	19.7	2.6	0.6	1.6	0.5	1.4	0.54	0.18	0.18	0.53	0.43
Argentina	1992	19.4	3.1	n.a.	2.7	n.a.	0.0	n.a.	0.33	0.22	0.24	0.33
Philippines	1993	4.5	1.1	0.7	0.5	0.53	1.3	0.47	0.28	0.26	0.44	0.48
Poland	1994	10.0	1.9	0.9	0.6	0.39	2.4	0.61	0.44	0.45	0.53	0.31
Ecuador	1994	4.5	0.6	n.a.	0.6	n.a.	0.0	n.a.	0.45	0.30	0.49	0.22
Bulgaria	1994	6.2	0.7	0.22	0.4	0.27	0.8	0.73	0.46	0.36	0.56	0.18
Panama	1996	1.9	0.1	n.a.	0.1	n.a.	0.0	n.a.	0.25	0.23	0.41	0.16

Sources: [Use of ESAF Resources for Commercial Debt and Debt Service Operations- Further Considerations](#) (EBS/97/94); Cruces and Trebesch (2013, 2014); Houben (1995).

1/ Fund-supported DDSROs were also conducted for Peru (1997) and Cote d'Ivoire (1998) but are omitted from the table due to data limitations.

2/ Face value in US\$ billions. Excludes past due interest. Includes debt restructured under new money options for Mexico, Venezuela, the Philippines, Poland, Panama

3/ In US\$bn Cash used for buy-back (i.e. market value of debt bought back) plus cost of purchasing collateral. Cost based on the time of the operations closing and, for Venezuela resources used to provide comparable collateral for bonds issued prior to 1990.

4/ In US\$ bn

5/ In US\$ bn. Calculated as "DDSR size" as reported in [Use of ESAF Resources for Commercial Debt and Debt Service Reduction Operations – Further Considerations](#) minus DDSR cost (column B) divided by total face value of debt restructured (column A). "DDSR size" is defined as "the sum of debt canceled through downpayments and buybacks, debt canceled through discounts, present value of debt service reduction, and prepayments of principal and/or interest guarantees (see Annex I of "Private Market Financing for Developing Countries" (IMF, 1992). "Present value of debt service reduction is estimated by discounting the below-market fixed interest rate path on the new instruments using expected future market rates (based on term structure of US Treasury bonds at the time of the AIP)."

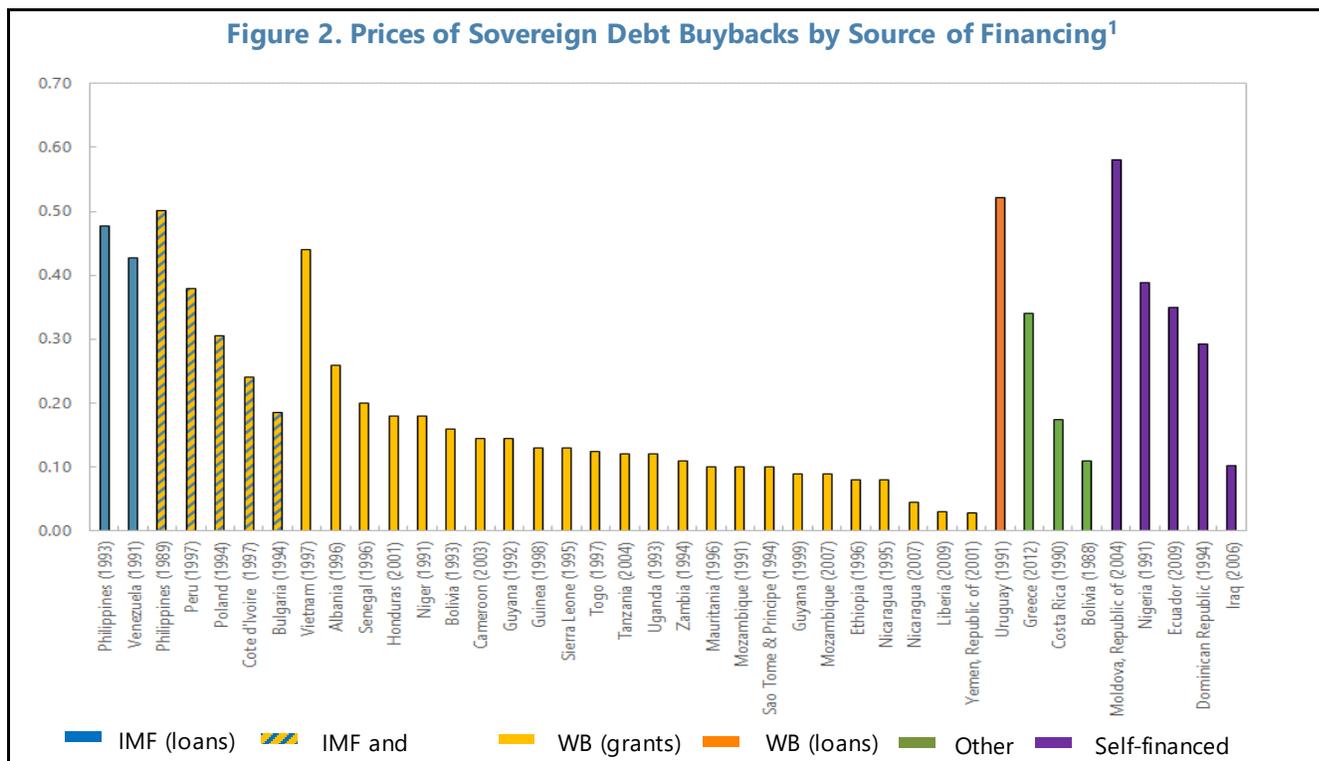
6/ Based on bond-by-bond staff calculation based on comparison of the face value of the old debt to the present value of the new debt using following as a discount rate: (i) LIBOR forward yield curve for LIBOR-linked coupon bonds, (ii) US zero-coupon bond yield curve for fixed coupon bonds with collateralized principal payments, (iii) US zero-coupon bond yield curve + TED spreads + LIBOR spreads for fixed coupon bonds with non-collateralized principal

7/ From Cruces and Trebesch (2013). Based on comparison of the face value of the old debt to the present value of the new debt, including "new money", using the "exit yield" following the restructuring as the discount rate.

**34. While the high debt relief achieved by Fund-supported buybacks as a percentage of face value bought back could reflect the fact that these buybacks were financed by de-facto preferred debt, buybacks financed by grants or own resources also led to high debt relief.**

Figure 2 shows buyback prices from 40 sovereign debt buybacks conducted between 1989 (Philippines) and 2012 (Greece), including the five IMF financed buybacks shown in Table 1. The figure shows that World Bank DRF (grant) financed buybacks occurred at lower prices on average, and hence involved higher debt relief per face value unit bought back, than IMF loan-financed buybacks. This reflects a selection effect, as DRF support can only be used in operations that involve a deep discount. Furthermore, since 2004 DRF supported operations were required to ensure full delivery of HIPC debt relief based on parameters agreed in the context of the Initiative. However, even buybacks funded by other sources, including the debtor’s own resources, occurred at prices that were for the most part in the same range as the IMF-financed buybacks of the 1990s. While this does not imply that the source of financing is irrelevant (disentangling this from other factors driving prices would require more analysis), it does suggest that cash-financed buybacks can lead to substantial debt relief.

**Figure 2. Prices of Sovereign Debt Buybacks by Source of Financing<sup>1</sup>**



Sources: Cruces and Trebesch (2013, 2014); [Use of ESAF Reports for Commercial Debt and Debt Service Operations - Further Considerations](#) (EBS/97/94), World Bank (2010). World Bank Project and Operations Database, Boughton (2001, 2012). IMF Country reports.

<sup>1</sup>Sources of financing are categorized based on whether financing was directly dedicated to buyback operation. IMF includes DDSR financing. WB grants include operations supported by the DRF. WB loans to support buyback operations includes buybacks financed by Debt Management Program Project loans (Philippines) and Debt and Debt Service Reduction Loans (Bulgaria, Poland, Uruguay). "Other" includes buybacks that received support from donor countries (Bolivia, Costa Rica) and the EFSF (Greece).

**35. Although buybacks achieved higher debt relief *per face value unit bought back* than the other DDSROs, they were also considered less efficient *per unit of upfront financing*.** At the time the DDSR policy was operational, the Fund used the concept of the buyback equivalent price (BEP) to assess the relative cost efficiency of DDSROs. The BEP is defined as the ratio of the upfront costs associated with a given debt operation to the amount of DDSR achieved through that operation (Table 2, column K). This measure provided a benchmark for assessing the relative efficiency of alternative options of DDSROs, and for comparing the overall terms of any specific DDSRO with the secondary market price (Table 2, column E). For example, if the BEP of a certain DDSRO (e.g., a debt exchange offering discount bonds with collateralized principal) is lower than the prevailing secondary market price, then the debtor was able to obtain a higher debt and/or debt service reduction per unit of upfront financing through that operation than what would have been possible by using the same amount of resources for a buyback at the prevailing secondary market price. Fund-supported deals involving buybacks had on average a higher BEP (37 percent), meaning they were considered less efficient uses of upfront financing than deals without buybacks, which averaged a BEP of 33 percent. Furthermore, the BEP for the DDSROs involving buybacks was typically lower than the secondary market price, suggesting that the overall debt operation was more efficient than the buyback portion.

**36. The fact that DDSRO as a whole achieved higher debt relief *per unit of upfront financing* than buybacks (using the BEP concept as a measure of efficiency) does not necessarily imply that financing collateral was more efficient than financing buybacks.** The BEP refers to the cost-efficiency of the entire DDSRO, which included (in most cases) the use of collateral in distressed debt exchanges.<sup>35</sup> It is likely that some degree of debt relief could have been achieved through a debt exchange with less or even without any collateral (which would entail a BEP equal to zero). At the same time, the net debt relief of that operation could well have been lower than the debt relief that was actually achieved (with the help of collateralization), as lack of collateralization may have forced the debtor to offer higher interest or face value in order to achieve the same degree of participation (following the logic described in Box 2). As happens with other credit enhancements, it is difficult to assess the standalone value of collateral empirically.

**37. The overall impact of Fund support in DDSROs on the debtor countries is hard to assess.** Available analysis of the DDSR policy at the time it was in place mostly focused on the BEP and relative efficiency among the menu of options, but it did not provide information on whether DDSRO support should have been considered in the first place. In other words, the counterfactual of supporting the member through a Fund-supported program following a debt exchange operation without *any* collateral or buyback component (as became the standard from 1999 onward) was not considered. Since it is impossible to observe this counterfactual, one cannot say for sure whether Fund financing of collateral or buyback contributed to the debt relief achieved by DDSROs, and by how much.

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<sup>35</sup>In addition to the fact that they were conducted in distressed circumstance (and hence under the threat of continued default), Collins and El-Erian (1993) suggests that participation in debt exchanges may have been bolstered by the fact that creditors extracted capital gains on the uncollateralized part of the new debt instrument, and because debt exchanges offered tax incentives through flexibility in recognizing losses gradually over time.

**38. Notwithstanding these limitations, there are indications that Fund-supported DDSROs benefited debtors:**

*Exit yields.* As explained in the previous section, a key argument for cash- and/or collateral-supported debt exchanges is that they can address creditors' distrust about the debtor's ability to repay, which can lead to an excessive risk premium. Whether or not Fund-supported DDSROs achieved this purpose can be inferred by comparing the exit yield premium (defined as the difference between the market exit yield and the risk-free interest rate) for these operations to similar deals that did not involve Fund support, or indeed any enhancements. Table 3 provides this comparison by comparing the exit yield premium in Fund-supported DDSRs with that observed in other Brady deals and in other non-Brady restructurings during the period.<sup>36</sup> On average, the exit yield premium in Fund-supported Brady deals was significantly lower (5.7 percent) than in non-Brady private restructurings that were completed over the 1990-2000 period (8.7 percent), even when these occurred inside a Fund program (7.9 percent). This suggests that Fund-supported DDSROs lowered investor risk perceptions over and above the impact of having a Fund program. Two Brady deals that involved a Fund-supported program as well as DDSROs financed from other sources and —Jordan and Vietnam—had similarly low premiums (5.8 percent). While these comparisons are not conclusive (both because they are based on a small sample and because they do not control for differences in the debtor fundamentals), they are consistent with the view that DDSROs lowered investor risk perceptions.

*Haircuts.* If a DDSRO succeeded in reducing the exit yield premium, then the "haircut" that the DDSRO implies for investors (in which the present value of new bonds is discounted using the exit yield) should be relatively close to the debt relief received by the debtor (in which a risk free rate or "normal borrowing rate" is used to discount the new debt – see Sturzenegger and Zettelmeyer, 2007). Indeed, Table 2 shows that Cruces and Trebesch (2013) estimate of the haircuts of debt restructuring operations from the creditor perspective (column L) is remarkably close to the net debt relief estimates shown in column I. This is consistent with the view that Fund-supported DDSROs were efficient in the sense of leading to a low gap between the losses imposed on investors and the debt relief benefiting debtors.<sup>37</sup>

*Literature.* As pointed out by Das et al (2012), the Brady Plan was widely regarded as a success, as it put an end to the 'lost decade' of the 1980s debt crisis and normalized debtor countries relations with creditors after years of protracted debt renegotiations. Furthermore, the Plan fostered a new wave of capital inflows to emerging markets, and sovereigns were able to re-access capital markets. Henry and Arslanalp (2005) showed that stock markets of debtor countries appreciated by an average of 60 percent in real dollar terms, and these countries also saw an increase in growth and investment. However, the paper noted that it is not clear that these benefits could be generalized to forecast the potential impact of debt relief on highly indebted poor countries. Berthélemy and

<sup>36</sup>Exit yields were taken from Cruces and Trebesch (2013) database. Risk-free (10-year US Treasury).

<sup>37</sup>A fuller analysis could compare the difference in debt relief and haircuts between Fund-supported DDSROs and other debt restructuring (in particular, debt exchanges that did not involve any credit enhancements or buybacks). Staff plans to undertake this analysis in future work.

Lensink (1992) pointed out the limitation of overly pessimistic calculations in previous studies (such as the concept of BEP) that did not take account of possible efficiency gain effects of the Brady deals, which is linked to the debt overhang hypothesis: a reduction of the debt stock may increase the efficiency of the debtor economy, because it removes some of the disincentive effects generated by debt overhang, such as those associated with the lack of confidence in the government policies. Gumbau-Brisa and Mann (2009) claimed that the success of the Brady Plan was related to the guarantees on the most sensitive part of the yield curve's risk premium, which was the principal value of the 30-year bond.

**Table 3. Exit Yield Premiums in Fund-Supported and Other Private-Sector DDSROs<sup>1</sup>**

	Exit Yield <sup>1</sup>	Risk Free Rate <sup>2</sup>	Premium
	A	B	A-B
<b>IMF-Supported Brady deals</b>			
Mexico (1990)	14.4	8.6	5.8
Venezuela (1991)	16.6	8.6	8.0
Argentina (1992)	11.2	7.0	4.2
Philippines (1993)	13.6	5.9	7.7
Poland (1994)	11.4	7.1	4.3
Ecuador (1994)	12.9	7.1	5.8
Bulgaria (1994)	12.9	6.6	6.3
Panama (1996)	11.7	6.4	5.3
Peru (1997)	10.2	6.4	3.8
Cote d'Ivoire (1998)	11.1	5.3	5.8
<b>Average</b>			
IMF-Supported Brady deals	12.6	6.9	5.7
Brady deals without IMF supported DDSR <sup>3</sup>	15.3	7.2	8.0
w/ IMF arrangement	12.4	6.6	5.8
w/o IMF arrangement	17.0	7.7	9.3
Non-Brady private restructurings <sup>4</sup>	15.2	6.5	8.7
w/ IMF arrangement	14.6	6.7	7.9
w/o IMF arrangement	15.8	6.7	9.1

Sources: Cruces and Trebesch (2014) and St. Louis Fed.

1/ Based on methodology by Cruces and Trebesch (2014).

2/ Based on average 10-year US Treasury Rate.

3/ Includes Brady deals with Fund arrangements in restructuring year: Jordan (1993), Vietnam (1997); and Brady deals without Fund arrangements: Brazil (1994), Costa Rica (1990), Dominican Republic (1994), Nigeria (1991), Uruguay (1991).

4/ Includes 31 non-Brady commercial restructuring operations completed between 1990-2000, including 8 with Fund arrangements.

## WHY A REVAMP OF THE 1990s DDSR POLICY IS NOT NEEDED AT THIS TIME

**39. The motivation and justification of the 1989 DDSR policy are rooted in its historic context, and do not easily carry over to the present.** As described in Box 3 and Annex I, the DDSR policy was born out of a specific confluence of political and economic factors which aimed at deep debt relief on a voluntary basis, while protecting the interests of commercial bank creditors to the extent possible. The original justification for a dedicated DDSR policy—enhancing the Fund’s catalytic role by signaling official support for DDSROs—no longer appears convincing (if it ever was). At the current juncture the Fund can signal support for a debt restructuring operation through a Fund-supported program in the wake of that operation, so long as the operation is expected to achieve the required degree of debt relief. Compared to the 1990s, this signal is more powerful as a result of greater Fund transparency. UFR staff reports are now published, and the adoption of the DSA framework has addressed some information asymmetries and has narrowed the gap between debtor and creditor expectations. These developments have strengthened the signaling effect of the Fund’s involvement more broadly, thereby lessening any additional signaling effect potentially associated with a dedicated DDSR policy.

**40. Under current Fund policies, economically efficient DDSROs can be supported without a dedicated DDSR policy that formally earmarks financing for that use.** Specifically, current Fund policies both give Fund members the flexibility to use Fund financing for DDSRO purposes and give the Fund sufficient control to prevent inappropriate use of Fund financing for DDSROs:

- As noted above, Fund financing may be used by members to resolve their BoP problems consistent with the member’s economic program, as represented to the Fund. This may include using a portion of Fund financing to support DDSROs. Thus, no special policy is *required* for a member to use Fund financing to support DDSR operations that help resolve the member’s BOP problem.
- At the same time Fund policies provide ample safeguards to halt financing if a member undertakes a DDSRO that is not consistent with resolving its BOP need. First, as noted above, the Guidelines on Conditionality require that the Board take into account both a backward-looking assessment of how the member has implemented its policies as well as a forward-looking assessment of whether the program remains on track and the member’s capacity to repay the Fund continues to be consistent with the required adequate safeguards. In this context, the completion or intention to undertake a DDSRO that is inconsistent with program parameters would be grounds not to complete a review. Second, the Fund’s policies on debt sustainability and financing assurances require that the member’s debt remain sustainable during the program and that the program remain fully financed throughout. A DDSRO that jeopardizes either element would halt Fund financing.

**41. Not specifically earmarking funds for DDSROs also has the advantage that it requires each member to internalize the opportunity costs of DDSRO financing.** Where a portion of Fund financing can only be used for DDSROs, it would not compete with financing available for general BoP support purposes. As a result, members may want to use this financing for DDSRO purposes even if there are better alternative uses. Eliminating earmarking requires the debtor to internalize the opportunity cost of using Fund financing for DDSROs, which helps to ensure that DDSRO financing is well spent.

**42. A potential argument for a dedicated DDSRO policy arises from the fact that earmarked Fund-financing of buybacks could lead to higher debt relief than when Fund financing is not earmarked** (see paragraph 22). Where a buyback is financed by a senior creditor with dedicated financing, the debtor country gets a larger share of efficiency gain, as bondholders are de facto subordinated. This is only true if the debtor country's exposure to the Fund rises as a result of the buyback. It is not true if access to Fund financing is determined independent of whether there will be a buyback or not, and the debtor subsequently decides to spend reserves on a buyback. This said, the evidence presented in the previous section (Figure 2) suggests that buyback prices have been low (in the order of 0.5 and often below) even when buybacks were financed by grants or own resources.

**43. Even if the benefits of earmarking were judged to outweigh the costs, however, those benefits could be realized under current policies without formal earmarking.** The Fund can set access levels to accommodate a BoP need arising from the financing for a buyback operation. Presumably, such access would be higher than it would be absent the DDSRO, and the intention to undertake the buyback operation as part of the Fund-supported program could be noted in the program documents. Where appropriate, this signal could be strengthened through use of a "floating tranche," which is a type of conditionality currently in the Fund's toolkit.<sup>38</sup> This tool ties a portion of the financing more closely to a particular measure—e.g., a buyback—by allowing the release of the financing only upon implementation of the measure.<sup>39</sup>

**44. Proceeding this way under current policies may be preferable to the re-adoption of a formal DDSR policy, because the latter could create the expectation that official-sector sweeteners will become a routine feature of future debt restructurings.** This is not desirable, as it may create the impression of a shift in policy, relative to the last three decades, in the direction of systematically using IMF financing to shield debtors and creditors from the consequences of their borrowing and lending decisions. The Fund's role is now primarily to set out the program parameters and provide a framework under which necessary economic measures are pursued to assist the member in resolving its BoP problems. As shown in IMF (2020),<sup>40</sup> debt restructurings benefitting

<sup>38</sup>Guidelines on Conditionality, Decision No. 12864, as amended, para. 13.

<sup>39</sup>While a portion of Fund financing is tied to the implementation of a measure, the financing released is not specifically earmarked to be used in support of that particular measure.

<sup>40</sup>[The International Architecture for Resolving Sovereign Debt Involving Private-Sector Creditors—Recent Developments, Challenges and Reform Options](#), September 2020.

from this mode of Fund support have been relatively swift and have achieved high participation. While there are circumstances, outlined in the section on the Economic Rationale for Fund-Supported DDSROs, in which Fund-financed DDSROs can make sense, there is no reason to expect or signal that they will become a standard feature in future debt restructurings. As shown in Box 4, the World Bank's financing of these operations is different in some ways from the Fund's for two reasons: first, it is in some operations funded through grants (rather than from funds that need to be repaid, as is the case for the Fund), and, second, it has previously, to some extent, operated against the backdrop of an initiative such as HIPC which determines the debt relief and pricing of the specific operation.

**45. With that said, the establishment of a policy covering DDSR support should not be entirely ruled out, even if it is not needed at this time.** In the event of a systemic crisis where a significant number of countries engage in debt restructurings, there may be a benefit in establishing a generalized framework that would signal a willingness of the Fund to consider augmenting access under arrangements to support enhancements that meet certain general criteria. In contrast to the earlier DDSR policy, staff would not advocate formal earmarking that could lead to a repurchase expectation if the money was not used for that purpose. However, as noted above, staff does not see a case for such a policy at this time.

## CONCLUSION AND ISSUES FOR DISCUSSION

**46. Fund-financed DDSROs may be appropriate if they raise debt relief and/or reduce debt vulnerabilities beyond what might be achieved by a standard debt restructuring (without credit enhancements) combined with a Fund-supported program.** Depending on the circumstances, such DDSROs could take the form of market-based debt buybacks financed by Fund lending or debt exchanges that are "enhanced" by offering creditors cash or collateral ("sweeteners"). The potential case for buybacks is that they could reduce the debt burden and/or specific debt vulnerabilities (for example, related to rollover risk) without necessarily incurring the costs of a debt restructuring (such as protracted negotiations and reputational costs). The case for the use of sweeteners is that they may raise creditor participation in circumstances in which alternative instruments (such as bigger "sticks") are unavailable or ineffective due of the nature of debt contracts, or because of political or reputational constraints. Furthermore, offering cash or collateral could in some circumstance lead to higher debt relief compared to offering only (uncollateralized) bonds. This would be the case if creditors underprice such bonds (reflected in high expected exit yields).

**47. The conditions outlined in the previous paragraph (and Figure 1) are necessary but not sufficient to justify Fund-financed DDSROs.** To be sufficient, two additional conditions need to hold.

- First, the benefits of DDSROs (in terms of higher debt relief, higher participation, or lower reputational costs) must exceed the opportunity costs, which consists in the reduction of financing available for standard balance of payment support purposes.

- Second, Fund-financed DDSRO operations must not turn the Fund into an excessively large creditor compared to the stock of non-multilateral debt that remains outstanding after the debt restructuring. Doing would raise future borrowing costs, complicate market access, and put Fund resources at risk, particularly if the restructuring does not restore debt sustainability with high probability.

**48. A dedicated policy that would allow Fund resources to be formally earmarked for DDSRO financing, as existed in the 1990s, is not required at this time.** Existing Fund policies allow members to undertake DDSROs in the context of Fund-supported programs, so long as DDSROs contribute to resolving the member's BoP problem. In addition, earmarking Fund support for DDSROs may not be desirable, as it would eliminate the trade-off facing members on whether to use Fund support for DDSRO or for standard BoP support purposes, which helps ensure that DDSROs are undertaken only if their benefits outweigh their opportunity costs. Furthermore, current policies would allow informal earmarking by setting access levels to accommodate planned DDSROs, and using "floating tranches" to create a link between disbursements and the implementation of DDSROs. Finally, the re-adoption of a dedicated DDSR policy could create the expectation that official-sector sweeteners will become a routine feature of future debt restructurings, which is not desirable. While there are circumstances—in particular, when debt crises are exceptionally deep and difficult to resolve—in which Fund-financed DDSROs could be useful, there is no reason to expect or signal that they will become a standard feature in future debt restructurings.

**49. Directors may wish to consider the following issues for discussion:**

- Do Directors agree that Fund support for a member's DDSRO may generally be appropriate in the circumstances outlined in the section on the Economic Rationale for Fund-Supported DDSROs?
- Do Directors agree that a dedicated policy on DDSR support is not required at this time?
- What priority do Directors attach to further work in this area, in particular to developing more specific operational guidance on identifying conditions in which DDSROs might be appropriate, and how they should be designed?

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## Annex I. Policy on Debt and Debt Service Reduction Operations

1. **The adoption of the DDSR policy was part of the Fund’s broader policy reforms in 1989 aimed at allowing the Fund to promote effective BoP adjustment while facilitating market-based restructurings.** Towards the end of the 1980s, while the debt burden of many developing countries worsened, these countries’ negotiations with commercial banks on suitable debt restructuring and financing packages became increasingly complex and protracted, undermining the Fund’s ability to provide timely financial assistance to these countries. In response, the Fund decided to modify its financing assurances policy so as to permit the approval of a Fund arrangement before banks had provided assurances as to their willingness to support a financing package consistent with assumptions of the program. In addition, the Fund also modified its arrears policy to allow the Fund to lend to members in arrears to commercial banks pending the negotiation of a voluntary restructuring agreement. At the same time, to help facilitate the negotiations, the Fund established the DDSR policy to make its resources available to members to help finance the up-front cost of DDSROs.<sup>1</sup>

2. **The DDSR policy imposed specific limitations on access to Fund financing for the support of DDSROs.** Under this policy, in a stand-by or extended arrangements—or since 1997 in an arrangement under the concessional Enhanced Structural Adjustment Facility—<sup>2</sup> Fund financing would be earmarked to support directly members’ DDSROs (see Box 5 on earmarking). The amount of Fund support for a member’s DDSRO would consist of set-aside amounts of around 25 percent of the total access under the relevant Fund arrangement for that member, and possible additional resources from augmentation of up to 40 percent of the member’s quota, with the augmentation to be added to the Fund arrangement for the purpose of applying the Fund’s access limit policy. The set-asides were subject to the requirement that remaining financing be available to meet the member’s general BoP need.<sup>3</sup> Set-asides or augmentations could be released once the member reached an agreement with its commercial bank creditors, and so long as the Board agreed that such resources would be used effectively in support of DDSROs.

3. **The DDSR policy required the Fund to verify the use of the set-aside amount by the member and would subject the member to early repurchase requirement when failing to use it properly.** The Fund’s decision to provide resources to a member’s DDSRO established a

<sup>1</sup>See [Fund Policy on Sovereign Arrears to Private Creditors](#)), pages 8-9.

<sup>2</sup>DEC/11533-(97/67) ESAF, adopted 7/2/1997.

<sup>3</sup>See [Fund Support for Debt Reduction Operations – Preliminary Considerations](#), (04/19/1989) (“At the same time, the set-aside must leave adequate margins to meet the member’s general balance of payments needs”); see also [Concluding Remarks by the Chairman Issues in Managing the Debt Situation](#), March 23, 1989 (“most Executive Directors pointed to the need to assure that sufficient resources would be available for general balance of payments support of stabilization efforts, which was and remained the key financing role of the Fund”).

mechanism to trigger the expectation of repurchase if the purchasing member failed to use the purchase of the set-aside amount for the specified purpose.<sup>4</sup>

**4. The experience of Poland provides a practical example of how the policy was applied.**

In the context of the 1994 stand-by arrangement, Poland received Fund support for DDSROs through both set-asides and augmented access. Upon agreement with commercial bank creditors, the authorities requested an augmentation of access and a release of the accumulated set-asides to assist with the financing of the commercial bank debt operation. The operation regularized USD 14.4 billion of commercial debt at an upfront cost of USD 1.9 billion, divided among debt buybacks and the purchase of collateral for principal.<sup>5</sup> The Fund determined that Poland's DDSRO was consistent with Fund guidelines: commercial bank participation was voluntary; the package was market-based and the terms of the operation were more favorable than secondary market conditions prevailing at that time; the authorities contributed a significant amount from the country's own resources; and the package constituted a crucial step in Poland's progress toward external viability. The estimated haircut for Poland's operation was 49 percent (also, as per Cruces and Trebesch 2013).

**5. Until its termination in 2000, the DDSR policy appears to have served well its purpose to help facilitate members' reorganization of their debt owed to international banks.**

Between 1989 and 1997, "some US\$120 billion of members' commercial bank debt has been restructured with Fund support" leaving at that time "a small residual" of "remaining cases of commercial bank debt to be dealt with".<sup>6</sup> The Fund's total financial support under the DDSR policy during this period was about SDR 3.1 billion, which was provided to 9 members in 10 DDSROs.<sup>7</sup> Thereafter, between 1998 and 2000, there was only one DDSRO of Cote d'Ivoire that received the financial support of SDR 51 million by the Fund under the ESAF.<sup>8</sup> In 2000 the DDSR policy was terminated by the Board, as the Fund did not foresee any upcoming DDSROs that would require earmarked Fund support.<sup>9</sup>

**6. The Fund policy on support for DDSROs was adopted to enhance the Fund's traditional financing approach and catalytic role.**

Up until early 1989, the Fund's discussion of its support for

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<sup>4</sup>Specifically, following the Fund's disbursement of the set-aside amount, if the member fails to use this amount for the specified debt operation purpose, the Fund may decide that the member is expected to repurchase the set-aside amount, and if the member does not make such repurchase as expected, the Managing Director is not allowed to recommend any approval of the use of the Fund's general resources. See [Debt and Debt Service Reduction Operations - Early Repurchase Expectations](#), (11/22/1989).

<sup>5</sup>See [Republic of Poland – Request for Financial Support for a Debt and Debt Service Reduction Operation](#).

<sup>6</sup>See [Use of ESAF Resources for Commercial Debt and Debt Service Reduction Operations-Further Considerations](#), EBS/97/94 (06/04/1997), pages 5-6.

<sup>7</sup>Nine countries received the Fund's support under the GRA for DDSROs, including Philippines 1989 & 1993, Mexico 1990, Venezuela 1991, Argentina 1992, Poland 1994, Ecuador 1994, Bulgaria 1994, Panama 1996, Peru 1997.

<sup>8</sup>Fund support was provided as part of the first disbursement under the 1998 ESAF arrangement. See [Cote d'Ivoire- Staff Report for the 1998 Article IV Consultation and Request for Arrangements Under the Enhanced Structural Adjustment Facility](#), EBS/98/36 (03/04/1998).

<sup>9</sup>See DEC/12185-(00/42), adopted 4/13/2000. The DDSR policy was among several facilities that were also terminated due to their obsolescence or redundancy following the Fund's comprehensive review of its GRA lending policies in 2000. See [Review of Fund Facilities—Preliminary Considerations](#), (03/02/2000).

DDSROs was still focused on its continuing role to provide policy advice and traditional, general BoP support under Fund arrangements, without specifically earmarking its financing for DDSROs. Under this approach, it was contemplated that the Fund's support for DDSROs could be done through proper setting of "[r]eserve targets and other performance criteria... to allow for the use of reserves for a cash buyback, purchase of collateral for an asset exchange, or to secure interest", and through catalyzing other financing for such operations.<sup>10</sup> Even after the announcement of the Brady Plan Directors expressed concerns that direct Fund financing of DDSROs would reduce the Fund's available resources for general BoP support of stabilization efforts and would be inconsistent with the Fund's role to provide catalytic financing.<sup>11</sup> To allay those concerns, the United States reportedly agreed that any Fund financing earmarked to support DDSROs were to be subject to the Fund's access limit policy, and this compromise helped gain support for the Brady Plan from the G-7 and later at the Interim Committee's meeting on April 3, 1989.<sup>12</sup> Thereafter in May 1989, the Fund's DDSRO policy was adopted by the Executive Board, which set specific limits on the set-aside and augmentation amounts of Fund resources that could be used to support DDSROs as described in paragraph 2 above.<sup>13</sup> As noted in Board papers proposing the DDSRO policy, the Fund's provision of direct financing to support a DDSRO under this policy would "signal strong official support for such operations and help foster the appropriate degree of debt reduction" through catalyzing targeted financing and speeding up a return to the market.<sup>14</sup>

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<sup>10</sup>See [Issues in Managing Debt Situation](#), (02/24/1989), page 8.

<sup>11</sup>Id. See also [Minutes of Board Meeting on the Debt Situation – Developments, Issues, and Role of the Fund, Concluding Remarks by the Chairman](#), and Boughton (2001) at page 494.

<sup>12</sup>See Boughton (2001) at page 494.

<sup>13</sup>Initially, set-aside amounts could only be used to finance principal reduction through buybacks and principal and interest collateral, and while augmentation amounts could only be used for interest support. In 1994, the Fund decided to eliminate this segmentation. See [Modalities of Fund Support for Debt and Debt-Service Reduction](#), (11/30/1993) and BUFF/94/2 (1/10/1994).

<sup>14</sup>See also [Minutes of Board Meeting on the Debt Situation – Developments, Issues, and Role of the Fund, Concluding Remarks by the Chairman](#), p. 16 ("The Fund's essential role would be to bring parties together in a cooperative strategy, although a seal of approval of the policies would primarily be given through the commitment of its own resources."); [Fund Support for Debt Reduction Operations—Preliminary Considerations](#), p. 3 ("A specific commitment of Fund resources for debt reduction could be justified as it would signal strong official support for such operations and help foster the appropriate degree of debt reduction."); [Fund Involvement in the Debt Strategy—Further Considerations](#), p. 4-5 ("A commitment of Fund resources at the start of the arrangement would provide a clear signal of official support for a member's economic program and external financing requirements, including debt reduction where appropriate.").

### Box AI.1. The DDSR Policy and the Fund's Approach to Earmarking

**The Fund does not currently require its financing to be earmarked for any specific use by a purchasing or borrowing member.** Under Article V, Section 3(a) of the Fund's Articles of Agreement, the Fund may only make its general resources available to members to assist them in resolving their balance of payments problems in a manner that establishes adequate safeguards for their temporary use.<sup>1</sup> The Fund's conditionality and lending policies are designed to implement these requirements under Article V, Section 3(a). While the Fund may require a member to use a part or all of Fund financing for a specific purpose, e.g., making a specific payment, (so called "earmarking") as long as such earmarking is consistent Article V, Section 3(a) requirements, the Fund has generally not done so partly due to the impracticality in tracing the use of Fund resources.

**The earmarking of Fund resources to finance only DDSROs under the 1989-2000 DDSR policy was an exception from this general practice.** The DDSR policy required a specified portion of the Fund's financing under a Fund arrangement to be earmarked, with that amount being released only when the member had reached an agreement to restructure its debt to commercial bank creditors, and so long as the Executive Board agreed that Fund resources would be used effectively in support of that member's DDSRO. In addition, between 1989 and 1994, the earmarked amounts under the DDSR policy were also segmented between "set-aside" amounts and "augmentation" amounts, which amounted to "earmarking within earmarking".

**Earmarking under the DDSR policy had been designed in compliance with the BoP support and safeguards requirements under Article V, Section 3(a).** The earmarking under the DDSR policy would not only help a member to address its special BoP need arising from its debt to international commercial banks, but also foster the member's successful DDSROs which was critical for the success of the member's Fund-supported program. In addition, only a small portion of resources under a Fund arrangement would be earmarked, leaving the remaining financing sufficient to meet the member's general BoP need. Further, the earmarked resources were provided as part of a Fund arrangement where relevant conditionality would apply, and in case of a member's failure to use the earmarked resources for its DDSROs, the member would be expected to make early repurchase of the earmarked amount that the Fund provided.

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<sup>1</sup>The BoP support and safeguards requirements also apply, *mutatis mutandis*, to the provision of PRGT resources.

## Annex II. Types of Credit Enhancements

CEs can take a number of forms—three specific types are guarantees, the provision of collateral and the use of first-loss structures in fund/SPV structures. In addition, there are other means of providing credit enhancement, including through the ‘sharing’ of preferred creditor status.

### Guarantees

Guarantees are unfunded risk-transfer instruments that involve the agreement of a guarantor to assume responsibility for performance of an action by another, with the promise to compensate the underlying beneficiary in the case of non-performance. Guarantees can be full credit, where 100 percent of the principal in present values terms is guaranteed (using the coupon as the discount factor), equivalent to a guarantee of all principal and interest payments, or partial credit guarantees, where a portion of interest/principal is guaranteed. They can be provided on a ‘rolling’ basis, with the guarantee of debt service that rolls from one interest payment to the next if not called. Such guarantees may be reinstatable or non-reinstatable: a reinstatable guarantee can be restored if the guarantee has been called but the underlying borrower repays the guarantor (often within a set timeframe).

### Collateral

Collateral is an essential element that underpins a range of lending in financial markets and can be attached to bonds to improve the credit of the overall package (bond + collateral). As a funded risk-transfer instrument, the underlying borrower will need to pay for any collateral that is to be used. Depending on the nature of the transaction, the collateral can be held by the creditor or by a third-party in escrow. The value of the collateral is linked to its underlying credit quality and high-quality securities (e.g. advanced economy sovereign bonds, or multilateral development bank securities) are typically used, which can make collateralization expensive.

### First-loss Tranches

A first loss tranche is generally structured as the most junior claim on the borrower or collateral assets, absorbing losses in a manner similar to equity capital. In the case of credit enhancement, a counterparty (sovereign, official sector or multilateral participant) will capitalize a fund/SPV by taking the most junior tranche (which will provide a first buffer against any potential losses in the purchased bonds), while private creditors will invest in the more senior tranches (which will have a higher credit rating). Such fund/SPVs will in turn use the proceeds received to purchase bonds in the primary or secondary market, in order to support an SDR.

## Other Types of Credit Enhancement

“Sharing” of Preferred Creditor Status (PCS): private creditors can indirectly rely on a relevant international financial institution’s (“IFI”) PCS, if financing or payment flows are structured in such a way that a payment default to the private creditors will also lead to a corresponding default to the IFI.<sup>1</sup>

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<sup>1</sup>As also noted above, arrangements of this nature could erode the informal consensus (in debt markets, and on the side of official bilateral creditors) supporting the de-facto preferred creditor status (PCS) of relevant international financial institutions. In particular, the World Bank will not engage in PCS sharing.