The Fund's Lending Framework and Sovereign Debt-Further Considerations
EXECUTIVE SUMMARY

Background. In discussing the June 2014 paper, Executive Directors broadly supported staff’s proposal to introduce more flexibility into the Fund’s exceptional access framework to reduce unnecessary costs for the member, its creditors, and the overall system. Directors’ views varied on staff’s proposal to eliminate the systemic exemption introduced in 2010. Many Directors favored removing the exemption but some others preferred to retain it and requested staff to consult further with relevant stakeholders on possible approaches to managing contagion. This paper offers specific proposals on how the Fund’s policy framework could be changed, presents staff’s analysis on the specific issue of managing contagion, and addresses some implementation issues. No Board decision is proposed at this stage. The paper is consistent with the Executive Board’s May 2013 endorsement of a work program focused on strengthening market-based approaches to resolving sovereign debt crises.

Increasing flexibility. Staff proposes changes to the exceptional access framework for cases where, although the member’s debt is considered to be sustainable, this determination cannot be made with high probability (i.e., uncertain or “gray zone” cases). The proposed changes would allow the Fund to lend in such cases with a less definitive debt restructuring (i.e., reprofiling) than required under the current framework if it improves debt sustainability and sufficiently enhances safeguards for Fund resources. First, the reprofiling may give breathing space to a liquidity-constrained sovereign and allow for a less constraining adjustment path, thus supporting growth and improving debt sustainability. Second, it could help catalyze domestic support for the program. Third, the maintenance of non-senior creditor exposure would provide safeguards for the member and the Fund in the form of the option to implement a more definitive debt restructuring later if needed, such as, in the event downside risks materialized. A reprofiling would also normally reduce the level of access to Fund resources needed by the member. Fourth, relative to a bail-out, a reprofiling would support market re-access prospects: creditors are more likely to re-engage when a larger share of the debt is non-senior claims since it reduces the risk of subordination to official sector claims in the event of a subsequent debt restructuring. A reprofiling would not be required if, notwithstanding the gray zone or uncertain assessment of sustainability, the member retains market access, or creditor exposure is maintained in other ways (including through new financing).
Dealing with spillovers from a sovereign debt crisis. Staff analysis consists of two parts:

- **Understanding the nature and type of spillovers.** The primary source of spillovers in a sovereign debt crisis episode is market concerns over the member’s solvency. Thus, a restructuring decision that is anticipated and seen as credibly addressing debt vulnerabilities may be less contagious than a bail-out that leaves the member’s debt problems unresolved and raises the default risk on the remaining private claims.

- **Managing spillovers from a reprofiling.** Spillovers from a reprofiling would be— and have been in previous cases—much smaller than those arising from a debt reduction operation involving principal haircuts. Also, some spillovers, insofar as they reflect a realignment of risk pricing with fundamentals, would be desirable and should be allowed to play out. Thus, an optimal approach would combine a debt operation, where needed, with policy interventions aimed at resisting market fluctuations not rooted in fundamentals. In this context, staff’s analysis of past crises reveals several options to prevent and manage spillovers: *ex-ante systemic measures* (clear “rules” of the game, including the Fund’s own policy frameworks for exceptional access and debt sustainability assessments, bank resolution frameworks that minimize taxpayer subsidies, and regional financing/support arrangements); *measures in the crisis country* (careful calibration of the scope of sovereign debt included in the reprofiling operation, backstops for the financial system, including from central bank); and *defensive measures outside the crisis country* (the standard menu of policy tools for mitigating capital flow and financial market volatility in affected countries, backed by supra-national firewalls and safety nets, such as swap lines, Fund resources, and regional financing arrangements).

**Removing the systemic exemption and addressing “tail events.”** Staff recognizes that there may be rare cases where policymakers conclude that cross-border spillover risks are so severe that defensive measures would be inadequate and hence any restructuring of private claims must be avoided. Resorting to the systemic exemption and an ensuing bail-out, however, is not an effective remedy in such circumstances. It may fail to limit contagion, since it does not address the source of the problem, namely the underlying market concerns about debt vulnerabilities. The systemic exemption also reduces safeguards for Fund resources since, if a debt restructuring is eventually needed, a smaller pool of private sector claims would be available to absorb losses. More broadly, by severing the link between underlying debtor risk and yields, the exemption encourages moral hazard and over-borrowing ex-ante, and exacerbates market uncertainty in periods of sovereign stress, as traders bet on whether the exemption will be activated, rather than focusing on underlying sustainability fundamentals. In an extreme tail-risk event, an alternative would be for the Fund to make exceptional access available provided that other official bilateral creditors are willing to provide financing on terms sufficiently favorable to address sustainability
concerns. Though it, too, would create moral hazard, this approach would be more effective than the systemic exemption in helping members address their problems (as Fund policy requires), mitigating contagion, and safeguarding Fund resources. The approach could be implemented flexibly and Fund lending could proceed on the basis of political commitments to backstop debt sustainability without necessarily requiring the specifics to be spelt out. Overall, given the proposed increased flexibility of the exceptional access policy, and the options to deal with spillovers and “tail events” within that framework, staff sees a compelling case for the removal of the systemic exemption.

Conclusion. The two proposals (i.e., increased flexibility and removal of systemic exemption) are a coherent package that, in staff’s view, should be adopted together.
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   B. The Proposed Text

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