Sovereign state-contingent debt instruments: Use by Issuers in Africa

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Why Sovereign state-contingent debt instruments (SCDIs)?

- **Strengthen the resilience of the sovereign debt portfolio**
  - Provide borrowers “insurance” against shocks
  - Benefit creditors by avoiding distress scenarios
  - Can be used to bridge high uncertainty about future path (e.g. positive upside surprises)

- ***Downside* protection to borrowers under negative scenarios.**
  - Insurance-like contracts provide *liquidity* relief to borrowers
    - Done through interest forbearance and/or maturity extensions following large negative shocks
    - Trigger linked to a specific, observable outcome

- ***Upside* payouts to creditors under positive scenarios.**
  - Value Recovery Instruments (VRIs) structured as call options or warrants
  - Tied to a state variable strongly correlated with the borrower’s ability to pay
  - Upside payouts usually spread into the future

Relevance of SCDIs to African countries

- **Vulnerability to global development and external shocks**
  - Commodity exporters
  - Growing risks from climate changes
  - Increased debt vulnerabilities

- **Sources of financing still limited**
  - Local currency bond markets still underdeveloped in many countries
  - Many countries do not have access to international capital markets
  - Concessional financing might not be available in a scale or timely manner

- **Earlier IMF work[1] found factors limiting adoption of SCDIs could be addressed by official support for contract design**

[1] See *State-Contingent Debt Instruments for Sovereigns*, IMF (2017) and *The Role of State-Contingent Debt Instruments in Sovereign Debt Restructurings*, IMF Staff Discussion Note (November, 2020)

Suitability of SCDIs for debt management

- **Preserve policy space in ‘bad times’**
  - Stabilize debt indicators or financing needs when it is most needed
  - Could diversify investors and creditors base

- **Careful instrument design is required**
  - Tie state variables closely to repayment capacity
  - For investor credibility, important to use state variables less subject to manipulation
  - Consider payments profile of linking to coupons, versus principal

- **Treatment of SCDIs in MTDSs and DSAs**
  - Baseline scenario for the evolution of debt service obligations
  - Alternative scenario analysis to capture their debt service impacts (positive or negative)

Recent use of SCDIs by African countries is limited to official lending

- **The Agence Française de Développement offers countercyclical concessional financing with a floating grace period for principal payments**
  - Debtor country has the right to exercise the floating grace period in the event export earnings fall below a predefined threshold
  - Repayments can be deferred up to five times after the threshold is met
  - These loans were used outside of restructurings and were included in part of Sovereigns' budget financing instruments

- **Currently, little appetite for market-based SCDIs**
  - Lack of established local currency bond markets in many countries
  - Frontier issuers that have access to international capital markets could face a reduced investors base
    - Expected cost might be too high for the SCDIs' risk reduction benefits

Many countries are not actively looking to issue SCDIs in the near term

- **Potential issuers would need to overcome moral-hazard concerns**
  - Debt transparency issues
  - Data linked to national statistics
  - Public financial management issues

- **Many countries could benefit from inclusion of SCDIs features in official (bilateral and multilateral) lending**
  - Countries could request that creditors include countercyclical features in their loans (could follow AFD model)