Restructuring domestic debt Must be credible, fast, comprehensive

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With the possibility of restructuring domestic debt increasing, there are concerns about the impact of such a restructuring on the financial markets. A limited restructuring, in which only government debt held by the Central Bank is restructured, is unlikely to resolve the fundamental issue of government solvency. Indications are that only treasury bills (T-Bills) held by the Central Bank will be restructured while restructuring of treasury bonds (T-Bonds) may be expanded to the rest of the market. An expanded restructuring involving private sector participants (and potentially public institutions) would, however, need to be managed carefully.

In a report issued by Verité Research in October 2022 titled The Desirability of Domestic Debt Restructuring, we provided calculations and analysis to show why the restructuring of domestic debt may be needed to help lift the economy from the current crisis. In that report, we proposed a maturity extension for domestic debt rather than any cut to the principal. In this article, I will assume that this is being considered and argue that the government must prioritize three objectives to successfully complete the restructuring of domestic debt: to be credible, to do it fast, and to do it comprehensively.

Exhibit 1:

Be credible

Two credibility issues are pertinent: 1) the ability to execute the restructuring legally, and 2) bank solvency. To address the former, legislation must be ready to provide the government with a clean and transparent way of enacting a debt swap (most restructuring scenarios involve swapping existing debt for a longer maturity at a pre-specified price). If the legality of such operations is questioned, or the execution is not professional, it would create speculation about the need for subsequent rounds of restructuring.

To address bank solvency, depositor protection and the capitalisation of banks should be focal points for policy. Depositors' protections can be credibly ensured through an increase in the deposit guarantee level: the rupees deposited at a bank that the government will guarantee in the event of a bank failure. A sufficiently high deposit guarantee level will reduce the incentive for depositors to withdraw their money in panic if they become fearful of the safety of their deposits. This in turn would lower the likelihood that banks experience difficulties, and ultimately reduce the likelihood that the government will need to pay on these guarantees.

The Russian government doubled deposit guarantee limits in 2014, ensuring the banking system did not (and still has not) experience(d) difficulties as it did in 1990s. Capital injections by the government into the banking system will also be a robust and credible signal to depositors that banks have sufficient capital even if withdrawals of deposits increase. In Britain, during the global financial crisis of 2008-2010, banks that had credible backing from the government through equity injections did not experience any large-scale deposit withdrawals, unlike banks that did not (Royal Bank of Scotland compared to, for example, Northern Rock, for which government support came slowly and in a piecemeal manner). This is despite verbal assurances from the Bank of England and the British government at the time about protecting the financial system, banks, and depositors.

Do it Fast

Continued discussions and uncertainty about the extent and timing of debt restructuring feeds directly into the yields on government bonds, which have stubbornly stayed at 2022 levels despite inflation falling. The possibility of any restructuring causes investors to increase their required yield, or return, on domestic debt. The uncertainty about how it will be done further adds a risk premium to the

yields and increases the government's cost of borrowing. The possibility of restructuring creates increasing discussion about the solvency of the banking sector, and with additional delays, the likelihood of panic increases. Finally, the possibility of restructuring causes market participants to alter their investment decisions inefficiently.

Rapid execution of any restructuring is critical. This can be achieved by announcing bank holidays on which the restructuring can be concluded. All debt must be restructured simultaneously, instead of in a staggered process that involves protracted negotiations with different bondholders. The simultaneous and rapid execution of the restructuring will prevent significant increases in uncertainty, volatility and disruptions in the bond markets which could potentially spill over into other markets.

Be Comprehensive

The impact of domestic debt restructuring will have first-order effects on the holders of bonds. Superannuation funds hold about 43% of T-Bonds, with banks and financial institutions, including insurance companies, controlling about 54%. On the one hand, retirees who rely on income from superannuation funds disbursements will be negatively affected. On the other hand, the government repaying this debt will mean that the burden of the crisis falls on the younger generation of workers and taxpayers. A balanced approach that facilitates intergenerational equity needs to be considered. This would involve an equity injection into superannuation funds by the government to offset the loss in asset value of such funds through restructuring.

As the likely mechanism for the restructuring will be a maturity extension, the impact on insurance companies is more challenging to determine. Insurance companies rely on matching the duration of their assets (roughly speaking, the maturity) with their liabilities (their expected insurance claims). An extension of the maturity/duration of their bonds would create a mismatch. The Central Bank of Sri Lanka can alleviate some of this strain by providing additional liquidity assistance to help manage this mismatch while their portfolio holdings are re-balanced.

Finally, and perhaps most importantly, domestic debt restructuring is intimately tied to bank solvency. Currently, banks are seeing a higher number of borrowers being unable to repay their debts, or non-performing loans (NPLs). This is particularly true of firms and state-owned enterprises. Restructuring domestic debt would further reduce the asset value of banks. Therefore, the loans of banks which are not being repaid should be bought from the banks and placed in an 'Asset Management Company' (colloquially known as a 'bad bank') that has the expertise and resources to manage these loans. The banks, in turn, would have additional cash on their balance sheets from the sale of these unproductive loans, creating an environment where depositors feel safer. The banks can extend new, productive loans to borrowers who are able to repay, thereby helping to grow the economy.

Asset Management Companies (AMCs) are special purpose vehicles ('SPVs') capitalized by the Government and/or the private sector that purchase (in exchange for cash or asset of sufficient liquidity) assets/loans from, typically originating, banks. AMCs have often been implemented following major economic and financial crises, such as the Asian financial crisis in the late 1990s and the Euro zone sovereign debt crisis which began in 2010, where they were used in Ireland, Spain, and Slovenia. The AMCs, in the latter case, were typically capitalized with government debt, which was used to purchase impaired assets from banks at a price close to, but below, real economic value. The banks could then use the government debt to access central bank liquidity. These AMCs have generally positively contributed to repairing and unblocking the investment channels in these countries. Sweden, an early adopter of AMCs in 1991-93 and Korea in 1997-98 (Korean Asset Management Company – KAMCO), benefited from an integrated approach to bank and asset resolution, along with a broad programme for recovery, in the face of financial crises.

The success of domestic debt restructuring will lie in the sequencing of these three criteria. Credibility needs to be established first, not through mere communication by policymakers but through policy and by 'putting money on the table'. Then the debt restructuring needs to be executed fast and without delay to reduce the costs and uncertainty in the period leading up to it. Finally, after the restructuring is complete, a comprehensive plan needs to be executed to resolve the structural issues in the banking system to allow its ultimate objective to be met. The banking and financial system needs to be the conduit for growth, not the government. The role of good policy will be to create an environment in which the banks can fulfill their role.

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