24 lending and borrowing countries and 4 international financial institutions and organizations gathered on October 11th, 2018 at the Paris Forum Workshop, which was held in Bali in the margins of the IMF and World Bank Annual Meetings, to discuss the costs and benefits of collateralized sovereign debt.

Recent developments regarding collateralized sovereign debt raised issues regarding its impact on debt sustainability and on debt restructuring. The Paris Forum Workshop’s goal was to analyze the cost and benefits of collateralized sovereign debt and discuss how to better take into account these debt instruments when assessing debt sustainability.

Collateralized sovereign debt may be seen by borrowing countries as an opportunity to fulfill development financing needs, as it can enhance credit access (when conventional financing is unavailable) and finance large capital expenditures. On the side of creditors, be them private or sovereign bilateral lenders, collateralized debt enhances their seniority as an asset securing the transaction - when economic conditions worsen, creditors are more likely to be paid than other conventional creditors.

However, in many cases, there is little evidence that collateralized debt brings more benefits than costs in the long term. Participants stressed during the workshop that these benefits may turn into risks and even imperil the borrowing country’s debt sustainability, especially when the level of collateralized debt is high:

1. **Lenders tend to base their lending decision on the value of the collateral, rather than on the borrower's financing capacity to service its debt.** This may lead to overborrowing and delay economic adjustment until a debt restructuring becomes unavoidable.

2. **These complex instruments might lead to “creative accounting” and misreporting of debt in the overall debt sustainability analysis.**

3. **In some borrowing countries, collateralized sovereign debt represent the larger share of the overall debt and sometimes of overall revenues, reducing the borrowing country policy flexibility by earmarking revenues or export earnings. It also encourages a “race to seniority” between lenders, while discouraging conventional borrowing.** Some multilateral and official lenders have included a negative pledge clause in their contracts, which prevents a borrower from pledging any assets.

4. **When a borrower’s debt is unsustainable and needs to be restructured, the resolution may be constrained i) as collateralized debt lenders consider themselves as more senior than conventional lenders, obscuring the creditor hierarchy and setting hurdles in burden sharing; ii) by the legal complexities that are often attached to the loan contract; iii) by the hidden debt that the borrowing country may have excluded from its balance sheet.**

To deal with these challenges, participants highlighted the need to improve debt transparency and sustainable lending practices as little is known on the scale of collateralized debt in developing countries.

Participants agreed that sharing data is a first step, but it does not solve the race to seniority nor legal issues when it comes to debt restructuring. **In a debt restructuring process, creditor coordination will be a key challenge to provide timely and orderly resolution of the debt crisis and ensuring fair burden-sharing among creditors.**

Collateralized debt is a complex issue that need to be discussed in debt fora, and addressed by IFIs and the G20. The Paris Forum is committed to engage in deeper discussions on this matter during its next annual conference.