

ALTERNATIVE APPROACHES TO SOVEREIGN DEBT RESTRUCTURING

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Serious gaps exist in the means available to deal with sovereign debt crises. In recent cases of sovereign default, both the debtor country and its creditors have paid large costs, in terms of lost economic activity and income and lost value of claims. Some people see these costs as necessary to discipline debtors to avoid default. Bankruptcy should be messy, they say. In the view of many, however, the costs incurred under the current international financial architecture are unnecessarily large, to the detriment of both the debtor and its creditors. Some in the private sector also point to the fact that they have been able to conclude agreements with countries that have accumulated unsustainable debt and have defaulted. They point to Ecuador as completed, and express confidence that Argentina can be dealt with when the Argentine authorities finally approach them for serious negotiations. But this is not good enough. The losses to the Ecuadoran and Argentine economies from the processes available in those two cases have been huge and, arguably, unnecessary. Thus, doing nothing should not be considered an option.

What then are the relevant alternatives for dealing with sovereign debt crises? There are essentially three:

1. A statutory approach to establish a universal legal framework to facilitate negotiations and to empower a supermajority of creditors to approve a debt restructuring agreement with a debtor country that would bind in minority dissenting creditors. This is the sovereign debt restructuring mechanism (SDRM) proposal

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of Anne Krueger, the first deputy managing director of the IMF. Although based on statute, this approach relies on decisions by creditors and is, in that sense, a market-oriented approach.

2. A broadening of the kind of collective action clauses (CACs) that are already included in some (mostly British law) sovereign bond issues and their incorporation into a wider array of debt instruments, possibly to include bank loans. These new and innovative contingency clauses would, *inter alia*, describe as precisely as possible the procedures by which holders of a specific debt instrument would interact with the sovereign debtor and among themselves in the case of a request by the sovereign for a restructuring of those claims. These proposals were first made by John Taylor, under secretary for international affairs at the U.S. Treasury.
3. A two-step process proposed by Ed Bartholomew and Ernie Stern of J. P. Morgan. In step one, creditors would effectively exchange outstanding debt for claims that include collective action clauses, which could then be used, in step two, to facilitate a restructuring agreement between a sovereign debtor and those creditors.

What is needed is a system that produces a promise of orderly resolution of unsustainable debt situations that can be activated in a timely manner and that can proceed with reasonable assurance of finding agreement without undue delay—that is, a process that has a reasonably predictable end game. Limiting the kind of disruption and dislocation to the economy that has been seen in too many recent cases can help preserve substantial value both for the creditors and for the country and its citizens, including the poor who often suffer the most as a result of the economic fallout from financial crises.

There are major issues posed in the search for a workable system to produce this desired result. How does one know when a country's debt is unsustainable and warrants an appeal to a bankruptcy mechanism? How can the incumbent government, and the relevant ministers and officials, be persuaded to accept that reality and approach creditors for relief? Who gets to decide or to vote on a final agreement? How is such an agreement to be made binding on potential holdout creditors? Where should a mechanism for dispute resolution reside? What is the role for the official community, and the IMF in particular, in all of this? And, how can leaders in other countries that may be tempted to appeal for debt relief through such mechanisms when such relief is not warranted be prevented from abusing the system?

The underlying question regarding judgments about the sustainability of a country's debt is, in the first instance, an analytic matter. But it is also a political issue, as the capacity to service debt by a sovereign is, in part, a matter of its willingness and ability to implement policies to generate the resources needed to service that debt. Debt can almost always be serviced in some abstract sense, through additional taxation and through the diversion of yet more domestic production to exports to generate the revenue and foreign exchange needed to service the debt. But there is a political and social, and perhaps moral, threshold beyond which policies to force these results become unacceptable. Where that threshold becomes binding in a particular country is, in the first instance, for the government to decide. But it is also a matter for judgment by the official international community, through the IMF, whether to accept where that line is drawn when its assistance is requested.

In supporting an adjustment program prepared by a country, the Fund is accepting the budgetary and balance of payments framework underlying that program and the debt service capacity incorporated therein. The Fund can neither avoid judgments on the sufficiency of the tax system in the context of the country's existing situation, in the capacity to meet certain basic needs in the economy, nor in the pace of adjustment projected for the external sector.

Thus, the issue of sustainability is not a matter solely of economic or financial analysis, though the best analytics available need to be brought to bear in such judgments. All of the proposals for sovereign debt restructuring rely on these broader judgments that must be made. Ultimately, it will be the willingness of the international community, through the Fund, to support a country in its adjustment efforts, both while it is negotiating with its creditors and after a deal is struck to provide relief, that will signal the acceptability of the government's decision about where to draw the line. It will be the Fund's willingness to commit resources to continue to assist the country in the context of its negotiated agreement with its creditors that will signal the acceptability of that agreement to the official community. This is consistent with the fundamental role of the Fund envisioned under all of the proposals.

What then are the elements of the three basic alternatives?

The Sovereign Debt Restructuring Mechanism

The SDRM, through a universal treaty, would provide a legal framework that would make binding the decisions of a supermajority of creditors in agreeing with a sovereign debtor on a restructuring of

its outstanding debt. Such agreement could either precede or follow an event of default, preferably the former as that could help minimize disruption and the associated costs to the economy and loss of value to creditors.

Under the SDRM, there would be five major features:

1. The sovereign debtor would have protection from disruptive legal action by creditors while negotiations were under way; this would be provided through a vote by a supermajority of creditors to approve a stay on litigation.
2. The creditors would have some assurances that the debtor will negotiate in good faith and will pursue policies—most likely to be designed in conjunction with seeking financial support from the IMF, that help protect the value of creditor claims and help limit the dislocation in the economy.
3. Creditors could agree to give seniority and protection from restructuring to fresh private lending to facilitate ongoing economic activity through the continued provision of, *inter alia*, trade credit (something akin to debtor-in-possession financing).
4. A supermajority of creditors could vote to accept new terms under a restructuring agreement; minority creditors would be prevented from blocking such agreements or enforcing the terms of the original debt contracts, that is, they would be bound by the decision of the majority.
5. A dispute resolution forum would be established to verify claims, ensure the integrity of the voting process, and adjudicate disputes that might arise.

Note that in all of this there are no new legal powers for the IMF. The decisions to be taken would be those of the debtor and a supermajority of creditors or, in the case of disputes, an independent dispute resolution forum. The Fund's role continues to be essentially that of signaling its willingness to support and provide financial assistance for the government's adjustment program.

This statutory approach has found broad support among the membership of the IMF. The advantages of the statutory approach proposed under the SDRM include the immediacy of its applicability to all sovereign debt upon the statute becoming effective, that is, there would be no transition period such as would be the case under the CAC approach; its uniform application across all debt and across all jurisdictions, that is, aggregation across all debt instruments or all classes of instruments would be possible; and the creation of a single dispute resolution forum to ensure integrity to the process and to avoid ambiguities of language or interpretation. It has been proposed

to establish the SDRM under an international treaty, most appropriately through an amendment to the Fund's Articles of Agreement. This would assure legal uniformity across all jurisdictions.

There are numerous specific issues raised by this proposal. For example, although it is the intent to bring as many of the claims against the sovereign under the umbrella of any restructuring agreement, it is recognized that it may be appropriate to define classes of creditors for voting purposes rather than to try to aggregate votes across all claims. At the same time, it is agreed that the number of such creditor classes should be kept small; that they should not be prespecified in a treaty, but dealt with on a case by case basis; and that approval by each class should be required to complete the restructuring, that is, each class should have a veto over the final agreement. This last point will require striking a delicate balance to ensure that the classification process itself does not create holdout problems.

There also seems to be agreement emerging that sovereign debts governed by domestic law and subject to the jurisdiction of domestic courts could be excluded from the SDRM. At the same time, however, the sovereign should take account of the overall restructuring process and secure the support of the international community and the holders of its international debt in any restructuring of such domestic claims. There is also some support for excluding official bilateral claims from the SDRM and dealing with them in the Paris Club format, but, again, in the context of close collaboration and coordination with the parties to the restructuring under the SDRM. This may require certain changes in the policies and practices of the Paris Club.

The issue here is not whether domestic debt or bilateral official claims should be included in the restructuring; in some cases they certainly should be. The issue is, rather, whether they are dealt with specifically under the SDRM or, instead, under a coordinated process in which procedures specific to, and possibly more effective in, dealing with those claims are employed. The latter seems to be the more widely accepted approach, although this, like many other issues, requires further discussion.

There has, as yet, been only limited consideration given to the modalities for a dispute resolution forum, but there appears to be a wide diversity of views on this within both the official sector and the private financial community, as well as among civil society organizations and nongovernmental organizations (NGOs). While the benefits of ensuring uniformity in legal interpretation under the SDRM are generally accepted, there is concern about consistency with national laws and the potential for political opposition. NGOs and others have

also raised fundamental questions about the role to be played by such a body. Some call for a forum that could act as an arbitrator on the political or moral validity of certain claims and on the sustainability of the country's debt in a poverty eradication development context. All see a need for strict independence of such a forum, both in appearance as well as in fact. In this regard, some question whether any organ linked to the Fund could, in fact, strike that independence.

There are many more details to flesh out before a robust proposal on SDRM can be put forward. In addition, there are important questions regarding the impact of any agreement on a statutory approach, or on CACs for that matter, on the access of emerging market countries to international capital markets. Differences of view on this point have hampered greater buy-in to both the SDRM and to the contractual or CAC approach, including by some of the emerging market countries themselves. Some say that either approach could lessen the appeal of the asset class, thus worsening terms for borrowers. Perhaps, but the opposite argument could be made and is supported by the limited evidence available (Eichengreen and Mody 2000, 2001). After all, domestic bankruptcy law is thought to make the market in domestic debt more, not less, efficient. Why not the same in international markets? This said, there could be a first-mover problem and it may take some time for both issuers and markets to get used to a world governed by either regime.

Finally, does such an approach have a fighting chance politically? Some early reactions, particularly in the United States—which would have a blocking minority on any amendment to the Fund's Articles—would say not. However, the debate has not yet been fully joined, a fully fleshed-out proposal on SDRM remains to be produced, and the possible shortcomings of the other proposals have yet to be fully understood. The support for further work on the proposal by the official community is clear. The International Monetary and Financial Committee (IMFC) asked the IMF “to consider the issues further and to develop, for consideration . . . a concrete proposal for a statutory sovereign debt restructuring mechanism to be considered by the membership.”

At the same time, the response of many in the private sector remains cool at best. As the letter from the International Institute for Finance to Chancellor Gordon Brown as chairman of the IMFC stated, “Continued official support for the “two track” approach involving both CACs and a sovereign debt restructuring mechanism (SDRM) runs the serious risk of undermining efforts to advance contractual changes. . . . We would encourage the official community to concentrate its energies on advancing with the private sector and

issuers efforts already under way to put in place CACs, not to thwart or jeopardize those efforts.”

Collective Action Clauses

The official community, including the G-7 and the IMF, has called for further efforts—even as the SDRM discussion continues—to better formulate and to encourage the use of CACs, including the more innovative contingency clauses proposed by Taylor. The more traditional clauses, which provide for majority enforcement and majority restructuring provisions, have been included in bonds issued in some jurisdictions (e.g., Britain) for some time. The official community has, since the endorsement of the G-10/Rey report in 1995, encouraged their wider use, but to little effect.

The contingency clauses proposed more recently are more ambitious than traditional majority action clauses and would include—

- representation clauses that would authorize a trustee of a bond holder syndicate to act as a channel of communication between its bond holders and the debtor at an early stage of a restructuring;
- initiation clauses that could provide temporary protection against litigation by a minority of bond holders; and
- aggregation clauses that would effectively aggregate creditor claims across different bond issues for voting purposes.

Two issues regarding CACs are being discussed simultaneously: one on the formulation and potential effectiveness of these more innovative clauses, and one on how to encourage greater use of both the traditional and the more innovative clauses. While continued effort is called for by all concerned, and the private sector holds out the promise for quick advancement on this initiative, it would appear that little real progress is yet coming out of either of these activities.

The recent initiatives to foster the use of CACs can be seen as an effort to mimic what could be done under an SDRM. The CAC approach is often described as “voluntary and market based,” but that does not distinguish it from the SDRM, which also relies on decision-making by the private creditors themselves. (The role of the IMF would be similar under either approach.) The essential difference between the approaches is that the CAC approach relies on the inclusion of various clauses in individual bond instruments (or bond and loan agreements) and would, as a result, leave jurisdiction to courts in the country or state under whose laws the debt instruments were issued. It is also the case, of course, that the current outstanding debt

of sovereigns would remain untouched until maturing obligations are replaced with new issues containing CACs.

There is little question that the inclusion of such clauses—if they can be formulated to be acceptable to markets and issuers across jurisdictions and if they could be included uniformly in all new debt instruments—would be a significant improvement over the current state of affairs. It would broaden the array of claims that would prescribe how a restructuring would be handled if that became necessary and it would bring some greater predictability to the process. That is all to the good, but is it enough?

Suppose that, as of tomorrow, widely accepted and far-reaching clauses were incorporated into all new claims on sovereign debtors. This is a heroic assumption, given the apparent difficulty in finding agreement on draft language for such clauses and given the views expressed by many private creditors and emerging market borrowers on the desirability of their inclusion in new issues. How would the prospects for an orderly restructuring in a case that warranted such treatment change? In the first instance, very little. It would take years for the current outstanding stock of debt to mature or to be replaced with new debt containing these clauses. But if we assume this issue can be resolved—say through a mega-swap of current debt instruments for new debt containing such clauses—or if we fast forward to a time when the maturity schedule/new issue process resolves the problem, what can be expected?

How much comfort could be taken from this situation? Could uniformity of language be ensured across all jurisdictions and across all instruments? Even if uniform or identical language was used—a global standard that is spoken of—could uniformity of interpretation across jurisdictions or acceptance of judgments and interpretation in lead jurisdictions be ensured?¹ How could aggregation be achieved, that is, if each individual credit instrument is voted separately, how are different outcomes across instruments reconciled? What would constitute a majority across instruments and who would rule on the existence of such a majority? Market participants remain highly skeptical of the need for or desirability of cross-issue majority action. Most supporters of SDRM fail to see how the assurances needed to produce a reasonably predictable and orderly process to restructuring can be secured without it. There are no clear answers to these questions. Thus, while the CAC approach attempts to mimic the statutory

¹Argentina has 88 bonds outstanding, issued in a number of jurisdictions. Moreover, none of its bank debt includes such clauses.

approach of the SDRM, it seems a distant second in providing assurances on the universality of coverage and interpretation that is at the heart of the SDRM approach.

There are important legal issues at play as well in considering the initial formulation of some of the newly suggested clauses. To design a procedural clause, for example, there would need to be a reconciliation of different legal traditions. Under U.K. law, a trustee has the right to litigate and the individual bond holders' rights (both to litigate and under majority voting) are curtailed. In the United States, however, even when a trust indenture is used (which is rare), each bond holder retains the right to bring enforcement action. Similarly, under U.S. law, most bonds employ a fiscal agency agreement; but the agent has no rights to act on his own and leaves all discretion to individual bond holders. As the proposed new clause would go even further in conveying authority to a trustee than does current U.K. law, and beyond anything used in international sovereign issues under U.S. law, it is not surprising that market participants are unenthusiastic.

Similar problems are seen in the formulation of an initiation clause. The drafting of such clauses remains vague, in particular as regards the conditions under which a sovereign could initiate the restructuring procedure and an associated stay.² It is difficult to see how this can be decided under either the SDRM or the CAC approach without envisioning a significant role for the Fund.

Thus, it seems there is a long way to go in formulating effective clauses even to accomplish the more limited aims of their proponents. Similarly, efforts to date to design effective mechanisms to encourage or cajole borrowers to seek inclusion of such clauses in their debt have met with little, if any, success. "Leading by example" by the major industrial countries through the inclusion of the traditional CACs in their debt is seen by few as producing any major effect on emerging market issuers. (Thus far, Britain and Canada among the G-7 have included such clauses, and the EU member states have agreed to do so in new bonds issued under foreign jurisdiction.) The possibility of fostering the inclusion of such clauses through a regulatory requirement, or a requirement for admitting an instrument to a market or for listing on an exchange, has received a mixed reception, including a negative reaction from the Securities and Exchange Commission in the United States, the largest issuing market. Efforts to encourage inclusion through IMF policy have also seen limited results. While all agree that the practice should be recommended in the context of

²This, however, remains an issue under the SDRM proposal as well.

Fund surveillance, it is unclear whether this by itself would have a major impact. Other proposals, such as making inclusion of such clauses a precondition for use of the Fund's financial resources or encouraging their use by levying lower charges for those members that do include such clauses, run into significant operational and legal issues.

It is perhaps not surprising that this effort has produced few concrete proposals. Resistance to CACs has been a persistent theme since the call in the Rey Report in 1995 to include them—even the more modest traditional clauses—in all bond issues. The recent efforts of the G-10 to work with private-market participants “to develop provisions that would facilitate the orderly restructuring of sovereign bonds governed by the laws of major jurisdictions” appear to have met with mixed results. Although the G-10 Ministers welcomed the report of the Working Group on this issue,³ it remains unclear whether the proposals for collective action provisions coming out of that effort, modest as they are, are acceptable to the private sector. The Working Group itself has not endorsed the more ambitious provisions originally suggested by Under Secretary Taylor; the private sector associations have not accepted a number of features of the G-10 clauses.

The Two-Step Approach

An intriguing twist on the CAC approach is contained in the two-step proposal by Ed Bartholomew and Ernie Stern of J. P. Morgan. Under this proposal, when a country with an unsustainable debt approached its creditors, there would first be an effort to exchange all existing debt for debt instruments (Interim Debt Claims or IDCs) containing CACs. Various incentives, including some up-front cash, would be offered by the debtor to induce creditors to accept the exchange. The new instruments would be made additionally attractive by structuring them to be highly liquid to permit the exit of those creditors so disposed. A stick, in the form of exit consents (as employed by Ecuador in 1999), could also be used to convince recalcitrant creditors that their rights would be significantly reduced if they held on to the original instruments.

The clauses included in the new instruments would describe the rules for creditor representation and for majority action. Once the original debt had been converted, the provisions of the IDCs would be employed to facilitate a restructuring agreement between the debtor and its creditors.

³Communiqué of the Ministers and Governors of the Group of Ten, 27 September 2002.

This approach cleverly deals with some of the problems of the CAC approach, in particular, the debt stock problem. Moreover, it has the inherent beauty of requiring no new legislation while accomplishing aggregation, and presumably deals with the potential problem of multiple jurisdictions and the risk of conflicting interpretations by issuing the IDCs under a single jurisdiction.

But basic questions remain. Will bondholders (or other claim holders) be willing to accept the IDCs? Where will a country in crisis (or near crisis) get the resources for the up-front cash inducement? Which CACs would be used and would they be up to the tasks in the second-stage restructuring? Will minority/holdout creditors, in fact, be made legally powerless, especially if they managed to accumulate concentrated positions in a particular instrument, making exit consents ineffective? Would the exit consents themselves be subject to challenge? And could all of this be done in a sufficiently expeditious fashion to limit the dislocation and disruption to the economy that is an important objective of this exercise?

These questions are not all without answers. But the workability of the proposal can be tested only in a real case. As either SDRM or the inclusion of innovative CACs will likely take some time, it may be that a case will present itself in which the two-step approach could be considered.

Conclusion

The protracted, and at times frustrating, discussion of involving the private sector in the resolution of financial crises periodically confronting countries has been energized and put on a more constructive operational footing with the proposals to create a SDRM or to expand the use of CACs. At the same time, it is important to remember the limited, although critical, role intended for any of these approaches. They represent just one element in a broad array of instruments being developed to help prevent crises as well as to better manage those that will, inevitably, still occur.

It remains the case that, among crisis countries, there will continue to be those that will require temporary support to see them through a genuine liquidity crisis, especially where the crisis has its origins more in overall market conditions than in domestic policy. In such cases, official financial support, at times possibly quite large compared with historical limits on access to Fund resources, may be appropriate. It will also be necessary to continue to seek ways to secure some involvement of private creditors in those cases where a spontaneous return to market access cannot confidently be expected

in the time frame assumed under an appropriate policy adjustment program. Such cases may require finding more or less formal devices to seek the maintenance of exposure, especially by short-term creditors, or to halt capital flight.

The debate over the relative merits of SDRM compared with a widespread use of CACs has been helpful in better defining the issues that must be confronted in successfully designing either a statutory or a contract-based system. However, unlike the contractual approach, the SDRM provides a universal, uniform regime that can aggregate claims across jurisdictions and that has a standing mechanism that can be activated both to ensure the integrity of the process and the resolution of disputes. Those who support ambitious CACs or approaches along the lines of those proposed by Bartholomew and Stern may be persuaded through further discussion and debate that SDRM, while starting with a similar premise, provides a more robust solution. It would seem difficult to be strongly in favor of ambitious CACs, with the implicit acknowledgement that collective action is an issue, and, at the same time, strongly oppose the more recent version of the SDRM.

At the same time, to favor only traditional CACs, such as majority action and majority enforcement clauses, which seems to be the temptation in some segments of the private sector, may be a recipe for only repeating the disappointing experience since the call for CACs in the Rey Report of 1995.

But much more work is needed to flesh out the design and see the creation of an SDRM. There is, of course, the need to secure political support for such a mechanism. There are also a host of technical and institutional issues still to be examined. A more explicit and credible process for putting in place a stay in the early stage of any appeal to activate the SDRM, and the associated role of the Fund, needs to be designed. So too with an effective, and timely, device to consider seniority to new credit. More work is also needed to decide the criteria for determining creditor classes that will produce balance and ensure coordination among those classes themselves as well as with creditor classes that may be excluded from the SDRM. More thought also needs to be given to the dispute resolution forum and to the need to ensure its independence.

There are broader issues as well that go beyond the SDRM. There is, for example, the matter of dealing with a systemic disruption to the private corporate sector in a crisis economy. In recent cases, domestic bankruptcy processes have been overwhelmed when corporate sectors have collapsed in the face of sharply depreciating exchange rates, increased interest rates, and a self-aggravating decline in domestic

activity. Although lessons need to be learned from recent cases of such collapse and better ways designed to deal with such situations, the SDRM itself, by facilitating early action, could help prevent the severe dislocation that ultimately undermines the corporate sector.

This is a large agenda, but the constructive debate to date on the various approaches put forward to deal with sovereign insolvency holds promise for finding a means to address this critical aspect of the international financial architecture.

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