Discussion Draft
12/6/02

Sovereign Debt Restructuring

Executive Summary

Financial crises in emerging markets have often been characterized by sharp breaks in confidence, financial volatility, and severe losses of output and market access. Concerns about such upheavals, reinforced more recently by the collapse of the policy framework in Argentina, have provided impetus for a search for more orderly approaches to crisis management.

The private financial community is actively engaged in this effort. The goal of its market-based approach is to avoid debt restructuring where still possible, to facilitate it where necessary, and to restore early market access. This approach would include a framework for early consultations between debtors and key creditors, making use of an advisory group comprised of leading private sector emerging market participants that would give way to a country-specific creditor group in cases where restructuring cannot be avoided. It would also feature the implementation of newly designed collective action and related bond clauses in order to minimize such free-rider problems as may, from time to time, arise. In fact, considerable progress has been made by the private sector in developing such clauses. This market-based approach would be designed with input from both the private and official sectors, and framed within a Code of Conduct to help guide the behavior of all parties involved. In an environment where emerging market investors and creditors face heightened global uncertainty and increasingly seek to minimize risk – and where flows to emerging markets have fallen back to levels last seen a decade ago – financial crises can only be managed effectively with a market-based approach. (See the Attachment for an outline of such an approach).

In contrast, most of the official sector's efforts over the past year have focused on the formulation of a statutory approach, the so-called Sovereign Debt Restructuring Mechanism (SDRM). The SDRM is an attempt to "create some of the features of a bankruptcy regime without creating a bankruptcy court." The stated objective of the SDRM is "to facilitate the orderly, predictable, and rapid restructuring of unsustainable sovereign debt, while protecting asset values and creditor rights." In some official quarters, the SDRM is also seen as key to limit the size of official financing packages in the future as well as an instrument to force burden sharing. However, it remains unclear how the presence of an SDRM would constrain political decisions in favor of or against official funding in any given case. As suggested in the recent G30 report, IMF access policies should be dealt with as a separate matter.

Market participants from emerging markets and financial centers alike agree that the SDRM is both unnecessary and counterproductive. While we note that the IMF is still revising the SDRM proposal, no changes in its specifics will alter our serious concerns about the SDRM's inherent problems:

- The SDRM rests on the false premise that there is an inherent collective action problem among private sector creditors in sovereign debt restructuring that precludes agreement. In fact, not one restructuring has been prevented from moving ahead by the actions of holdout creditors. Moreover, creditors have been willing to act early and constructively as evidenced by the spontaneous formation of bondholder committees in the cases of Ecuador and Argentina.

- Implementation of an SDRM would render collective action clauses meaningless by overriding, in advance, the clauses' intended operation with a statutory mechanism. Moreover, its very pursuit has made implementation of clauses more difficult; the shadow of the SDRM may have already had an adverse effect on private sector flows.

- An SDRM and associated exchange controls that could affect international credit lines, create incentives that could themselves precipitate a crisis as creditors act defensively at the first sign of a problem and advance the rundown of short-term exposures and even accelerating long-term exposure. As a result, this would increase the risk that a crisis occurs, as well as intensifying it.

- The analogy between an SDRM and private sector bankruptcy legislation is fundamentally flawed: private companies are subject to jurisdiction of the bankruptcy tribunal. Even under an SDRM, the sovereign debtor would inherently not be subject to the appropriate checks and balances that legitimize and make a bankruptcy regime fair and effective.

- The selective coverage of debt under the SDRM effectively creates subordinated classes of debt, thereby increasing funding costs to borrowers and possibly restraining them from obtaining investment grade ratings. Moreover, the proposed coverage will leave the mechanism applicable only to a small number of cases since most recent crises were triggered by external debt of the private sector or domestic debt of the sovereign (such as Korea and Russia, respectively).

- The SDRM would force cases that may appear unsustainable, such as Brazil in 1999, toward long, costly, comprehensive restructurings, when informal, more surgical solutions might restore market access and growth at a much earlier stage. Paradoxically, the SDRM could shift more of a country's financing requirements to the official sector.

- Using debt sustainability as a trigger for the SDRM is fundamentally flawed. While the IMF has a useful role to play as an agent of adjustment, its role as *de facto* judge of debt sustainability presents major problems due to the acknowledged complexity of the task and the Fund's vested interest as a creditor.

- Despite its complex voting arrangements, the SDRM does not in fact resolve the problem of aggregation across different classes of debt, which is one of its principal goals. The private sector believes the issue of aggregation can be better – and more simply – addressed through greater transparency during the restructuring process.

Capital markets are built on the fundamental principle of enforceability of contracts. By making "structured" default – without the appropriate checks and balances such a regime normally includes – an alternative to policy adjustment, an SDRM represents a radical departure from this fundamental principle. It would appeal to those political forces in emerging markets that look for easy alternatives to policy discipline making it more difficult for finance officials to convince others of the need for adjustment. The resulting shift in expectations is also likely to have a highly adverse effect on private sector flows.

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Background: Past Experiences with Market-Based Restructuring

The premise of this paper is that market-based solutions are the only viable means of addressing international financial crises. Moreover, a brief background illustrates that the purported "free rider" or "holdout" problem described by the official sector as requiring a supra-market, statutory solution is neither a relevant justification for the SDRM nor a circumstance that the market is unable to address. First, there have always been a small number of free riders or holdout creditors, only some of which have pursued legal action. During the 1980s, banks' incentives to minimize write-offs coupled with occasional pressure from the banks' home regulators and the long-term commercial interests and reputation of banks themselves largely overcame the impact of free riders.

- In the Brady exchanges of the late 1980s and early 1990s, the "menu-of-options" approach was created together with the collateral structure underlying the Brady-bonds to respond to differences in commercial bank interests and to increase bank participation. The menus were also tailored to individual country circumstances and adapted to the developing secondary market for emerging market debt.

Second, the success of this "menu-of-options" approach has been replicated in recent debt exchanges where legal and financial measures have been used to make the offers more attractive to creditors with different time horizons, risk appetites, and investment constraints. While some of these measures have been viewed as unfair by some investors, the technique of a debt exchange has been used to avoid cumbersome voting provisions often requiring unanimity. Partly as a result, the influence of free riders on debt restructurings has not increased despite the proliferation of creditors and instruments during the course of the last 10 years:

- The outcome of three high-profile debt exchanges – albeit not the result of debtor-creditor negotiations – showed participation rates of 99 percent in the case of Pakistan, 97 percent in Ecuador, and 99 percent in Ukraine.

- Even in the long and drawn-out restructurings with Russia, the participation rate was 96 percent in the first exchange in December 1997 and over 99 percent in the second in August 2000.

- We also disagree with the assertion by many in the official sector that the Brussels Court of Appeals' decision in the Elliott vs. Peru case – is a prime example of rogue creditor behavior that justifies creation of an SDRM. There, the Court ordered Peru to pay Elliott at the same time it paid its other creditors through Euroclear; but at no stage did Elliott prevent Peru's Brady restructuring from moving ahead. Moreover, Peru itself had been in default for 18 years; yet Peru was both able to, and did, pay its Brady creditors as well as Elliott.

The private financial community therefore considers the SDRM proposal a disproportionate and potentially counterproductive response to the nature and size of any collective action problem that could arise during the process of restructuring sovereign debt.

Drawbacks of the SDRM

While free riders have not been an obstacle to reaching comprehensive debt restructuring agreements, it may be useful to consider means of limiting the potential for disruption in the future. However, the SDRM provides an unnecessarily heavy-handed apparatus for introducing what the official sector believes will be greater orderliness to the process. The proposal has undergone a number of modifications since its launch one year ago and the current version has reduced the role that was originally assigned to the Fund as the *de jure* arbiter between debtors and creditors. Nevertheless, the Fund remains the *de facto* judge on debt sustainability and as such the linchpin for authorities to be able to trigger the mechanism. The proposal has multiple additional drawbacks and runs the risk of causing unintended adverse consequences.

1. Jeopardizing Private Sector Initiative on Clauses. The work by the private sector groups has proceeded on the assumption that the G-7 Ministers and Governors share the view that this initiative to develop marketable bond clauses is the preferred approach for making sovereign debt workouts more orderly. However, this assumption has been undermined by the reinforced support for the SDRM by the IMFC in late September. Thus, it may now become prudent and necessary for the private sector to review financing terms in the context of a possible overriding SDRM. Such a review would cover *inter alia:*

- Revisiting the move away from unanimity requirement for a change in payment terms;
- Introducing earlier or automatic rights of acceleration (with the attendant risk of precipitating a “race to the court house”);
- Formulating more stringent rules of engagement that could make it more difficult to get bondholders agree to a restructuring;
- Requiring tougher substantive covenants and events of default.
- Introducing a possible bias against unsecured and longer-term credits in favor of collateralized and more highly structured financings and shorter tenors.

The result of such a review will inevitably be to delay the implementation of the clauses and possibly jeopardize their viability altogether.

2. Precipitation of a Crisis With the SDRM at its disposal and access to Debtor in Possession (DIP) funding, a country would be in a position to act quickly on a decision to declare its debt to be unsustainable and to suspend its payments. In such an environment, creditors are likely to react defensively at the first signs of potential financial trouble. As in today’s markets, those lenders who have an ability to react on short notice – providers of trade credit, interbank funding, off-balance sheet transactions and other short-term lenders – would be able to bring down their exposures as conditions in the country worsen and risks rise. In a world of an SDRM, this tendency would be exacerbated, since private creditors with claims on private sector borrowers, which are excluded from an SDRM targeted at sovereign debt, would have to fear the imposition of exchange controls.

The SDRM and associated exchange controls, therefore, would simply advance the timing of the rundown in exposure and do nothing to impede it. As a result, the "capital preserving" feature of the SDRM stemming from the sovereign's ability to initiate a stay at its own discretion would be undone through market anticipation of the potential early move by the sovereign. Moreover, the development of a crisis may become even more unpredictable as debtor and creditor actions interface in a dynamic setting under an SDRM, an outcome at variance with the stated goal of the IMF.

Perhaps even more importantly, the potential application of exchange controls could drastically disrupt trade flows that are the fundamental conduit for economic growth. Moreover, the sheer confusion that can be created as regulations are issued – and likely to be modified on a daily basis as loopholes are discovered and repaired just to create new ones – to enforce such controls would complicate the restoration of normal financial arrangements as demonstrated during the Russian GKO restructuring process.

3. Subordination Raises Funding Costs. The selective inclusion of certain private sector claims and exclusion of others will effectively subordinate the former to the latter. This *de jure* subordination of private sector debt – as compared with the *de facto* subordination that now occurs but has not been conceded – would restrict private sector flows further, increase funding costs, and jeopardize future investment grade ratings. In fact, there are already signs that the market place anticipates some of these effects**.**

4. Exclusion of Claims. The official sector has argued that reducing uncertainty about the restructuring process is the *raison d'être* for the SDRM. At the same time, Management and the Board of the Fund have left the issue of coverage of debt open for now. A case-by case determination of coverage would create high uncertainty that runs in conflict with the purpose of the SDRM. Perhaps more importantly, if debt is judged unsustainable, all debt should be considered eligible for restructuring. If a significant portion of the debt is excluded *a priori* – or will be treated more favorably – there is likely to be strong resistance to the proposed restructuring from those being asked to accept its terms. Of course, whenever possible, short-term trade credit should not be restructured because it is the foundation for international trade and medium-term credit flows.

The proposal to exclude Paris Club debt from the SDRM suggests that the official community believes that the Paris Club restructuring process has worked satisfactorily. The Fund has also argued that special treatment of Paris Club creditors is required due to their ability to provide early financial support. This reflects a selective view of the record of Paris Club negotiations, which have not always proceeded quickly as evidenced by such cases as Poland and Russia. This blatant inequity in the treatment of private and official bilateral claims allows bilateral creditors to continue to operate in a system that at times afforded them more favorable terms.

A number of important cases involved the controversial use of IMF resources, a feature that the SDRM has been targeted to cure. The examples of Russia in 1998 and Mexico in 1994-95 perhaps stand out in this regard. At the same time, these two cases would have not been addressed by the SDRM since they were primarily related to domestic debt problems. Efforts to exclude domestic debt from the SDRM appear to be driven by the recognition that politicians in industrial countries would not support the SDRM treaty if domestic debt were subject to treatment under the mechanism.

5. Delay of Market Access. The SDRM is seen by many in the official sector as a way for achieving a comprehensive restructuring at lower economic costs than those associated with the prevailing informal case-by case approaches. However, the SDRM could lead to the unwarranted initiation of a time-consuming debt restructuring process when a temporary, voluntary standstill might suffice. The result of this would likely be an extended period during which renewed access by a country to capital markets is delayed, therefore paradoxically shifting more of a country's financing requirements to the official sector. By contrast, more surgical, informal, and voluntary solutions are likely to lead to a rapid shift in investor confidence and early-renewed market access.

- After a period of extreme uncertainty in early 1999 which could have argued for activation of the SDRM, Brazil's arrangements with commercial banks in March 1999 to maintain short-term credit lines in the context of a strong IMF-supported adjustment program contributed to renewed confidence that enabled Brazil to place a $2 billion Eurobond issue in May.

6. Judging Debt Sustainability is Inherently Complex. The analysis of debt sustainability is extremely sensitive to assumptions on key macroeconomic variables, which in turn are a function of both the financial support provided to the country – official and private – and the degree to which the government is willing and able to implement needed adjustment measures. The private financial community recognizes the useful role the IMF has played in program design, as agent of adjustment, and as catalyst for private flows. However, investors are concerned about the IMF's role in determining sustainability in the context of an SDRM due to the lack of any provision for a market input into that judgment and the IMF's status as an interested party. With regard to the latter, investors see a conflict because the IMF may well be overexposed vis-à-vis a given country but its exposure would not be covered by the SDRM. Moreover, the Fund's prospects of receiving repayments may be enhanced in some cases.

In a recent paper entitled *Assessing Sustainability*, the IMF stated that the application of its tools for determining debt sustainability "has not been sufficiently consistent and disciplined to always ensure the credibility of the Fund's overall assessment of sustainability."

- The Mexican crisis in 1994-95 represents a case where several traditional indicators, including the current account balance and short-term debt signaled trouble but did not trigger warnings from the IMF about debt sustainability.

- At the same time, the resolution of the crisis without debt restructuring facilitated the quick reflow of private capital ($12 billion net in 1996 compared with net repayments to official creditors of nearly $11 billion) and the resumption of growth, which averaged 5.5 percent per year in 1996-2000. By contrast, a comprehensive restructuring that could have occurred under an SDRM would have delayed renewed market access and adversely impacted growth prospects.

Recognizing its own weak performance, the IMF has undertaken to develop a new framework that incorporates calibrated sensitivity tests to determine the implicit likelihood of default. This approach, however, does not explicitly link the external, fiscal and financial sectors and does not take into account the views and sentiment of private sector creditors. At the same time, the Fund's sustainability assessment assumes a certain profile of private sector flows but such projections are not discussed with market participants.

7. No Complete Solution for Aggregation. Although one of the key rationales for the SDRM has been that it would solve the aggregation problem, the most recent IMF staff paper acknowledges that the SDRM is not likely to accomplish that result. In fact, its proponents have argued that an SDRM could accomplish what collective action clauses could not, including limiting the risk for a minority of creditors with a certain type of claim being unfairly treated by a qualified majority of creditors holding different claims. Under the SDRM, support by a qualified majority of creditors in each class would be required to approve the restructuring terms offered to all classes. However, since all classes would be required to approve the overall restructuring, each creditor class would have *de facto* veto power over the terms offered to other classes of creditors. As a result, this approach *per se* does not guarantee quick success in reaching a comprehensive agreement.

Under a market-based approach, greater transparency on the part of the debtor regarding proposed restructuring terms for various claimant groups would be an essential ingredient in order to overcome the aggregation problem by permitting creditor classes to better understand and negotiate restructuring terms. It should also be noted that lack of formal aggregation has not posed a problem for debt restructurings in the past.

8. Abrogating Creditor Rights. In previous versions of the SDRM proposal, a stay of litigation was seen as being either unilaterally imposed by the debtor or endorsed by the IMF. In its current form, a stay is to be agreed by a (unspecified) super-majority of creditors. However, it seems unlikely that even a relatively low super-majority of creditors would be willing to enter into such an agreement with the possibility that they would have no recourse to react in a situation where the debtor would not act in good faith. Political turmoil such as has occurred in Argentina could result in a situation where the debtor would be unable to move forward in a restructuring process.

In this connection, the recent attempt to strengthen the "good-faith" criterion under the IMF's policy of lending into arrears has not resonated with investors. According to the revised policy, the "formal negotiating framework would include, *inter alia*, the sharing of confidential information needed to enable creditors to make decisions on the terms of a restructuring and the agreement to a standstill on litigation during the restructuring process." The implication of this statement is that "confidential" information sharing is contingent on an agreement to a stay. This further adds to the distinct impression that once the IMF determines that debt is unsustainable, the circumstances would be biased toward a stay, increasing the probability that this will lead to a broad-based default and restructuring.

While investors and creditors need to avoid unnecessary litigation, its potential can be addressed without an SDRM that overrides contractual arrangements and deprives creditors of the right for a judicial review.

9. No Quick Implementation. The SDRM also foresees the possible need for exchange controls and the creation of a Sovereign Debt Dispute Resolution Forum (SDDRF). In order to accommodate these features, there would be a need to amend the IMF Articles of Agreement. This whole process is likely to take a minimum of two to three years. The main reason for this is that any amendment to the IMF Articles of Agreement needs legislative approval by 85 percent of the IMF's voting power and by 60 percent of the IMF's membership. Since its inception, there have been three successful attempts to amend the articles. The average time for approval once the amendments were received by the membership was 22 months. These amendments dealt exclusively with how the IMF itself operates. However, the SDRM proposal would be using the Articles as a surrogate for changing international law. In this circumstance, it seems likely that the length of time required for approval would exceed the average. Moreover, if implemented, it is likely that the first application of an SDRM would be challenged in court, possibly taking years to sort out, thus creating a new type of market uncertainty unknown to date.

Moreover, one key issue arises as to the ability of the official sector to create a body that is independent from the Fund such as the SDDRF by amending the IMF Articles. By definition, anything accomplished through the Articles needs to have some relationship to the Fund itself. To create a truly independent body, it would be necessary to establish a new legal framework. Such an endeavor would require even more time to implement.

10. Enhancing Debtor Moral Hazard. Concerns have risen among investors and creditors that the adoption of the SDRM will increase the likelihood and frequency of restructurings going forward partly because political pressure could build to use it. In particular, the introduction of the SDRM could sanction a shift in sovereign credit culture making default an acceptable alternative, fundamentally breaking with the past. By providing a legal basis for formal stays and subsequent restructuring, the SDRM could contribute to an environment in which some politicians may be under the illusion that following this approach is a relatively attractive alternative to painful reform measures. Especially if domestic debt holders are excluded from the mechanism, governments with populist approaches could consider default as creating sufficient room in the fiscal account to pursue social goals.

Attachment

A Market-Based Alternative That Makes the SDRM Unnecessary

Since early 2002, the private financial community has intensified its search for a more effective approach to crisis management that would solve more problems than it creates. It is essential that such an approach be market-based and developed within a comprehensive framework to strengthen the global financial system, cope with crises flexibly as the need arises, and encourage sustainable private capital flows to emerging markets. Our goal is to develop and implement a marketable approach to collective action clauses that would operate in the context of an international Code of Conduct for crisis resolution to be applied on a case-by-case basis. As stated on numerous occasions, the resolution of such cases would not necessarily involve extraordinary official support packages. We are firmly of the view that we are well advanced in the effort to achieve these goals.

A market-based approach would lead to prompt resolution in cases where comprehensive debt restructuring appears to be unavoidable, while avoiding some of the unfortunate consequences of an SDRM. In fact, such an approach would make an SDRM unnecessary. As part of our approach, we have been working to develop new bond clauses that would help facilitate effective restructurings where unavoidable while protecting essential creditor rights. This approach represents a proportional and more appropriate response to the concerns that need to be addressed in the restructuring process, and limits the risks to future capital flows from the private sector.

The private sector's model clauses would:

- <u>Majority Action</u>. Permit the amendment and waiver of key Bond terms (including payment terms, as well as governing law, submission to jurisdiction, waiver of sovereign immunity and other substantive covenants as appropriate) by approval of a super-majority of Bonds outstanding.
    - May be approved by written resolution as well as at Bondholder meeting.
    - Bonds held or controlled, directly or indirectly, by the Issuer to be excluded from the voting calculation.

- <u>Engagement</u>. Provide for the appointment by Bondholders of a Committee to represent Bondholder interests, after an Event of Default has occurred or the Issuer has initiated restructuring discussions, in connection with such discussions with the Issuer and other creditors. Committee may adopt such internal rules as it sees fit and engage legal and financial advisors, subject to reimbursement by the Issuer.

- <u>Initiation.</u> Require 25% Bondholder vote to accelerate principal for Event of Default and provide for a super-majority vote to rescind acceleration.

- <u>Transparency</u>. Provide for SDDS and rolling forecasts, as well as reporting of proposed treatment of other creditor groups. Provide for greater use of financial community websites for notices and other information.

The private financial community is also of the view that collective action, engagement, and initiation clauses on the one hand and steps to strengthen transparency and creditor protections on the other hand are inseparable components in any future changes to bond documentation. This position is based on the informed judgment that investors will accept making bonds easier to restructure only if, at the same time, greater efforts are made, contractually and otherwise, to ensure that making them easier to restructure will not simply result in their default and/or restructuring becoming more likely. To that end, the private sector is proposing to work with issuers to develop better early warning mechanisms, as well as more transparent documentation and disclosure practices.

For these model clauses to become a global industry standard, it is important that they be adopted on a market basis by underwriters, investors, and issuers. For investors, it is crucial that transparency and creditor protection be enhanced in exchange for greater ease of restructuring where needed, and that collective action clauses (CACs) are not seen as a slippery slope leading toward a process that could abrogate basic creditor rights or increase the likelihood of default. For issuers, it is essential that the price impact of new contract clauses is minimal, and that inclusion of CACs is perceived as a sign of strength, not weakness.

Another key element of such a market-based approach is creation of a framework for dialogue on individual crisis cases in order to improve upon the current approach of ad hoc communications. Early consultation between the debtor and its key creditors can help policymakers identify measures that avoid upheaval, restore confidence and avert a deepening crisis. In fact, successful efforts at this stage can reduce significantly the number of cases requiring sovereign debt restructuring.

An informal, country-specific advisory group comprised of leading market participants from a broad spectrum of financial institutions could provide a mechanism for such consultations. Such a group could be initiated when a country is facing performance challenges but market access is sustained, or when early signs of vulnerabilities emerge and investor confidence is slipping. Such a mechanism could complement the important work of the IMF Capital Markets Consultative Group that focuses on systemic issues.

The advisory group could discuss and, if needed, help authorities develop basic strategies for halting the erosion of confidence and for embarking on a path toward rebuilding credibility. At the same time, such a consultative mechanism could reinforce the desire to avoid unduly large official packages and focus instead on the catalytic role of IMF financing. In cases in which broad debt restructuring by public and private creditors may be required, the advisory group would give way to constructive dialogue between the debtor country and a broad spectrum of creditors reflected in a creditor group. As indicated in the pending case of Argentina, the bondholder community has already shown an increased ability to form such creditor groups.