Enhancing Sovereign Debt Restructuring

Randall S. Kroszner

Since the early 1980s, patterns of emerging market finance have changed significantly. Greater integration of capital markets and a trend toward a greater use of direct lending through bonds has led to relatively decreased use of indirect finance through syndicated bank loans. These changes have produced benefits to investors through opportunities for risk diversification and to emerging market sovereign borrowers by increasing the investor base.

The broadened investor base in bond financing, however, raises problems of coordination and collective action in the event of a sovereign borrower's default and restructuring. Now, three parties are involved in determining the "debt markdown" required to produce solvency—the debtor, creditors, and the global taxpayer through international financial institutions (IFIs).

The complex relationships among the borrowers, creditors, and the global taxpayer have made restructuring obligations a costly and time-consuming exercise, especially with the possibility of "holdouts." Both the sovereign and its creditors have an incentive to avoid a restructuring in the hope of financial assistance from the global taxpayer. Sovereigns may not undertake the politically painful steps involved in beginning a restructuring when there is always the hope that official assistance will be forthcoming. Creditors may not accept a reduction in the value of their claims, also in the hope that official assistance will be forthcoming. Costs of postponed and disorderly restructurings are real and substantial. Delays in restructuring can drain a country's

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resources and increase the ultimate costs of restoring financial sustainability. Creditors bear a burden as well, because the losses associated with the restructuring are reflected in values of bonds.

Proposals for Enhancing Sovereign Debt Restructuring

These observations about the costs of sovereign debt restructuring are not new. Many studies have been conducted and proposals advanced, including the 1996 Rey Report of the G-10, and suggestions by the Bank of England and Bank of Canada and by academics, including Jeffrey Sachs of Columbia University and Adam Lerrick and Allan Meltzer of Carnegie Mellon University. Other proposals have been put forward by the International Monetary Fund and the U.S. Treasury to address the problem of sovereign debt restructuring.[1] First Deputy Managing Director Anne Krueger advanced the IMF's sovereign debt restructuring mechanism (SDRM) for amending the IMF Articles of Agreement to impose standstills and stays on legal actions by creditors. And Under Secretary of the Treasury for International Affairs John Taylor put forward the Treasury's position, which centered more on the reform of financial contracts.

The IMF and Treasury proposals view the coordination problem between sovereigns and their creditors in a different light and therefore offer a different solution. The SDRM proposal sees legal challenges from holdout creditors as the main obstacle to a sovereign restructuring. From this perspective, protection for the sovereign from holdout creditors is required to encourage the restructuring process, and under the SDRM proposal, this protection would be provided by an amendment to the IMF Articles that would allow for a sanctioned stay while a restructuring proposal is put together.

The Treasury proposal promotes a voluntary or market-based solution that calls for the increased use of collective action and representation clauses to formalize *ex ante* the interaction between the sovereign and its creditors in the event of a restructuring. To increase usage of this approach, the proposal envisions financial carrots and sticks wielded by the official sector to encourage the adoption of such clauses in new contracts that might also replace existing contracts.

On the eve of the World Bank and IMF meetings, the G-7 Finance Ministers and Central Bank Governors described the progress on their April Action Plan on crisis prevention and resolution:

[1]For a summary of the proposals, see Bingham (2002).

> We continue to work with the IMF to improve our tools for crisis prevention. We also will continue to work with the IMF to implement criteria and procedures to limit official sector lending to normal access levels where extraordinary circumstances justify an exception. Important progress has been made towards a market-oriented, contractual approach to sovereign debt restructuring. We welcome the private sector and issuing countries' support for placing collective action clauses in sovereign bond issues. We agree that any sovereign that issues bonds governed by the jurisdiction of another sovereign should include such clauses. We welcome the work done to date by the IMF on a statutory sovereign debt restructuring mechanism, and look forward to considering a concrete proposal at its spring meeting.

I will elaborate on these themes and, in particular, try to provide a means to clarify the possibility of official financial assistance through the IFIs. Unless and until policies for official intervention are clarified, sovereigns and their creditors will face a costly and complex process for negotiation. An important part of an overall solution is a mechanism to make sure that the cost of providing IFI resources is as transparent as possible.

Contractual Modifications

The contractual approach—involving clauses in debt contracts that encourage creditors and borrowing countries to undertake negotiations aimed at an expeditious, but orderly, restructuring of unsustainable sovereign debt—is an essential first step to addressing sovereign debt restructuring. A set of model clauses can encourage creditors and borrowing countries to undertake negotiations aimed at an expeditious but orderly restructuring. Contractual modifications could include (1) collective action and sharing clauses to deal with possible holdout creditors, (2) collective representation clauses to structure discussions among creditors, and (3) exit consents to encourage participation in exchanging old debt instruments for new ones.

The key lever for holdout creditors in a restructuring is the conventional requirement that all creditors agree to any amendments to the payment terms of a bond.[2] By contrast, the incorporation of collective action clauses would allow a supermajority of bondholders (say, 75 percent of holdings of an issue) to agree to amendments to the payment terms of the bond, and the decision would bind other

[2]Under U.S. law, such a requirement exists for corporate borrowers under the Trust Indenture Act of 1939, but not for sovereign borrowers.

bondholders. The inclusion of sharing clauses would also force a creditor receiving a disproportionate payment under a multicreditor instrument to share the payment on a pro rata basis. The inclusion of collective action clauses and sharing clauses would mitigate the holdout problem and speed the restructuring process.

Renegotiations and restructuring would be more streamlined if a trustee could represent bondholders at the beginning of the restructuring process. Current issues allow the trustee only to summon bondholders for meetings, but the incorporation of collective representation clauses would permit the trustee to represent the bondholders in initial restructuring discussions. Although sovereign borrowers may be wary of calling bondholders together (for fear that such a meeting might facilitate an acceleration of claims), those borrowers might be more willing to contemplate a restructuring if preliminary and nonbinding discussions could be held. This clause would also spell out the process by which a sovereign would initiate a restructuring and how the debtors and creditors would come together in the event of a restructuring. Such clauses might create a creditors committee that would coordinate relations with the sovereign, similar in spirit to the bondholders' committees that have operated in the United Kingdom and the United States.

Restructuring is also more likely to occur if bondholders are discouraged from "holding out" in hopes of receiving better terms. Exit consents are one mechanism that can help discourage holdouts. When exchanging old bonds for new bonds as part of a restructuring, existing bondholders (if a majority) can modify the nonpayment terms of the old bonds to make retaining the old bonds unattractive, thereby discouraging holdouts. The use of exit consents worked well in Ecuador in 2000, where exiting bondholders agreed to remove cross-default and negative pledge clauses.[3] Moreover, an exchange could be encouraged by a one-time financial enhancement from the official sector.

Of course, it is important that these clauses be included in all contracts—bonds and bank loans and perhaps trade credit—and these clauses must allow for aggregate collective action and representation across all the instruments. Achieving this inclusion is a tall order, especially given that contractual clauses in each instrument may not be able to address disputes among holders of different bond issues or different classes of creditors (e.g., banks, bondholders, and IFIs). To address this coordination problem, a sovereign debt dispute

[3]Such a strategy may be difficult to implement if there are many small issues.

resolution forum, similar to that proposed by Anne Krueger, could bring together debtors and all classes of creditors.

Sovereign Debt Dispute Resolution Forum

The forum would be established so creditors could work together with debtors to restructure debts and resolve disputes. Under U.S. domestic law, for example, a bankruptcy court supervises a creditor committee that develops a workout plan for a firm that has filed for bankruptcy. In the sovereign debt context, a standing committee could perform an analogous function. A country in distress could turn to a Sovereign Debt Dispute Resolution Forum that would then bring together the different classes of creditors to work out a restructuring plan that would involve all of the relevant claimants.

Anne Krueger has proposed such a dispute resolution forum to deal with the coordination problem among the creditors. In Krueger's proposal, a statutory change would be made in the IMF Articles to allow the IMF Executive Board to create and appoint members of the forum and give the forum the power to approve and enforce the work of the creditor committee, much like a domestic bankruptcy court does. This change would require a vote by 85 percent of the members of the IMF. Given that the members would be appointed by the IMF, there might be concerns about the forum's independence. In addition, because this change requires amendments to the Articles, it is likely to be a slow and difficult process.

An interim step that might be considered could be to create a voluntary body first in order to understand how well it can function.[4] It would be worthwhile to encourage the formation of such a voluntary forum and observe the effectiveness of its operation. If it proves to be ineffective, then the case for statutory change is even stronger. If the forum were effective, then the difficulties of reopening the IMF Articles perhaps can be avoided.

The forum's role could be acknowledged by inserting a clause in each debt instrument that would name this forum as the venue for negotiation and resolution of sovereign debt claims. The forum could operate akin to a domestic bankruptcy court in that a borrower could approach the forum and request the initiation of proceedings for a restructuring. The forum would then notify creditors of the request by the borrower and then operate as an administrator of creditor claims. The forum would convene a committee to monitor the voting

[4]On the role of private markets and institutions in financial reform, see Kroszner (1999a, 1999b, 2000).

process ensuring the orderly and timely restructuring of debt. The exact details of the structure of the forum can be left up to the market participants.

Access Incentives in the Restructuring Process

Serious discussion of sovereign debt restructuring must also be mindful of the call by the G-7 Finance Ministers and Central Bank Governors to work more with the IMF on access limits. From an economic perspective, one consideration that is relevant for both the contractual and statutory approaches to sovereign debt restructuring is the possibility that creditors and debtors lack incentives to come to the table in a timely fashion to begin a restructuring process. An all-or-nothing resolution is not necessary: One could provide incentives that would help avoid IFI lending into unsustainable situations. Access incentives need not place a rigid quantitative limit on the use of IMF resources, but would instead provide incentives for countries to curb access and enter negotiations to restore sustainability. These incentives would reinforce the important idea that official financing should be complementary to restoring private-sector growth.

The Bank of England and Bank of Canada sovereign debt restructuring proposals also highlight this important issue (Haldane and Kruger 2001). Their proposals call for strict limits on IFI assistance that would foreclose on the "wait for a bailout" option and encourage the troubled sovereign and its creditors to come to terms. This is a valuable proposal that focuses on a key problem.[5] Yet, the approach would limit policy flexibility. Any change to the existing financial structure should act as an incentive to encourage appropriate official financing rather than impose strict limits unconditionally. Again, what is needed is a mechanism to make sure that the cost of providing IFI resources is as transparent as possible.

Creditworthiness and Economic Growth

These key changes—contractual modifications, a dispute resolution forum, and clarified official financing—are likely to bring greater order to the sovereign debt restructuring process. It is important to remember, though, the reason for reforming the restructuring process: It is the encouragement of private sector growth and private

[5]The proposal notes the IMF has long had the ability to lend beyond normal limits (300 percent of quota) by invoking the exceptional circumstances clause or though provisions by Supplemental Reserve Facility. The proposal argues that the definition under which the IMF is allowed to lend beyond the limits is left purposefully vague.

capital flows that will lift the prospects of economies around the world.

With this concern in mind, any discussion of improving prospects for restructuring of sovereign debt must take place in the broader context of improving creditworthiness in emerging market economies in order to nurture and sustain rational capital flows that promote economic growth. Ultimately, the borrowing capacity of an economy depends on its ability—especially that of the private sector—to generate returns for investors. The real cost of funds to emerging market borrowers reflects both the general real interest rates in the international capital market and compensation for the risk of default and for substandard investor protection regimes.

Recent research by economists suggests that gains from encouraging investor protection and good corporate governance practices can be substantial. Most analysis of financial liberalization approaches the issue from an asset-pricing perspective that focuses on changes in the risk-free rate or the price of systematic risk (or both) as a consequence of improved international diversification. Removing barriers to capital flows does not, however, guarantee that capital flows to its most efficient use unless international investors can be credibly convinced that investments will be repaid; the expected return to investors depends on the level of investor protection. It is interesting in this light that recent research finds that the preexistence of an Anglo-Saxon legal system (with generally strong investor protection) magnifies the response of investment to financial liberalization events.

The creditworthiness of the private sector in emerging market economies can be enhanced significantly by making progress toward meeting best-practice standards on accounting practices, creditor rights, and contract enforcement. Judgments on a country's progress would be based on the existing Reports on the Observance of Standards and Codes. If countries have made sufficient progress, then IFI guarantees could be put in place to encourage needed contractual modifications to debt instruments. This framework would allow the IMF to encourage steps that enhance creditworthiness and the ease of restructuring without having the IMF assume a central adjudicatory role during a financial crisis.

Conclusion

This framework fits hand in glove with President Bush's "new compact for development" that increases accountability for rich and poor nations alike by linking greater contributions by developed nations to greater responsibility by developing nations and emerging market

economies. More broadly, the Bush administration believes that policies that facilitate and encourage economic growth in emerging markets should receive the greatest possible attention from international financial institutions. Proposals to reduce costs of sovereign debt restructuring should not be inconsistent with an emphasis on economic growth.

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