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G-24 Secretariat Briefing Paper On Sovereign Debt Restructuring

I. Introduction

The lack of an orderly and transparent framework for restructuring sovereign debt is a major gap in the international financial architecture. The informal but more or less standardized procedures followed in the 1980s to resolve a government's financial predicament after it became unable to meet its external payment obligations are no longer sufficient, principally because bonds have become a prevalent instrument for international sovereign borrowing since the 1990s. The one formal international mechanism in use, which is for the heavily indebted poor countries (HIPCs), has a number of shortcomings, including a long period needed to pass through the process and concerns about the adequacy of relief at the end of it (see separate note on HIPC debt relief). A workable system is needed that can produce orderly and effective resolution of unsustainable debt situations without undue delay.

Two broad approaches to the matter have been explored recently. The first approach is aimed at middle-income countries that access bond financing. It would add new clauses to each sovereign bond contract specifying how to carry out restructuring of the bond issue in crisis situations, including a pledge to follow a code of good conduct on crisis resolution should a default occur. The second approach could apply to all countries, although it has mainly been discussed in the context of middle-income countries. It would establish an international statutory framework that would make it easier for a sovereign debtor and specified majorities of its various classes of creditors to reach an agreement that would be binding on all creditors as well as the debtor. The International Monetary and Financial Committee (IMFC) of IMF has endorsed work on both approaches ("two-track approach"), although the G-7 and G-10 have increasingly leaned toward the first approach. Also, the G-24 has indicated its preference for voluntary, country-specific and market-friendly approaches to restructuring.

II. The contractual approach

Under this approach, sovereign debtors would put new clauses into their standard bond contracts to cover the contingency of bond restructuring. A central concern is to prevent a small minority of creditors from sabotaging the restructuring and thus the clauses specify what majority would be needed to approve a change in the financial terms of the bond. These holdout creditors, often characterized as "vulture funds",

would typically buy the bonds at distressed prices and hope to collect full face value. Many in the financial markets argue that the threat of disruption is overdrawn, although they admit it exists.

In addition, representation clauses (specifying how debtors and creditors would come together in the event of restructuring), initiation clauses (describing how the sovereign debtor would initiate the process) and commitments to keep bondholders informed on the proposed treatment of other creditors would be included. Furthermore, the borrowing government and the bondholders would pledge to follow a code of conduct for both crisis prevention and crisis resolution, which would broadly stipulate the respective roles that key parties would be expected to play during times of crisis. There are various proposals for the content of the code, including one from a group of private sector organizations and another from the Banque de France ("Trichet Proposal").

The concept of Collective Action Clauses (CACs) is not new. CACs are incorporated in sovereign bonds governed by the laws of the United Kingdom and Japan. About 30 per cent of the total outstanding volume of emerging market sovereign bonds now includes CACs. There is no evidence that these bonds trade at a discount to bonds without this feature. However, most bonds are subject to New York law, which does not include CACs and under which all bondholders must agree to any amendment of payment terms.

The contractual approach has several shortcomings. One is that even if bond contracts were written so as to bring holders of all outstanding bonds together to vote on a bond restructuring (called aggregation across debt contracts of the same class), the problem would remain to coordinate relief given by bondholders with that of other classes of creditors ("comparable treatment"). Proponents of CACs have recently responded to this criticism by advocating the inclusion of the same clauses in all private loan contracts (bonds, bank loans, trade credits, etc.) and the formation of a voluntary forum to organize the negotiations and resolve disputes in individual cases, introducing a major aspect of the statutory approach described below, but as a voluntary device. Another substantial weakness is that if the clauses were included only in new issues it would take many years before all outstanding sovereign bonds of any country would have these clauses.

To promote the use of such clauses, European Union Member States have pledged to include them in their own government bonds issued under foreign jurisdictions. Before that decision, only Canada and the United Kingdom had CACs in their foreign currency bond and note contracts. Meanwhile, both the official community through the working group of the G-10 and private creditor associations have been drafting sets of model clauses. The objective is to make common practice the incorporation of such clauses in external sovereign bonds issued both under New York and English laws.

These efforts are already bringing some results. In late February 2003, Mexico became the first large emerging market issuer to include CACs in its newly issued $1 billion New York law governed bonds. This Mexican issue will allow creditors holding 75 per cent of the bonds to modify the payments terms. There was no evidence of a CAC premium priced in the new bond. In fact, Mexico was not the first to include CACs in a New York law governed bond. It had been done earlier by Egypt (2001), Lebanon (2000) and Qatar (2000). However, Mexico was the first large emerging market issuer that had publicly announced including such clauses in the bond issuance. This may help emerging market issuers to embrace this practice more broadly.

III. The statutory approach

Ms. Anne Krueger, the First Deputy Managing Director of IMF, proposed creating the Sovereign Debt Restructuring Mechanism (SDRM) in November 2001. While it was revised several times in response to public reaction, the core feature of the proposal remained to enable a debtor in crisis and a qualified majority of its creditors to make a restructuring agreement binding on all creditors in all the covered classes of debt through a formal international process. Thus far, the proposal has not been endorsed by any group of countries, although IMFC had called for development of a concrete proposal that IMF has worked on for the past six months.

Under that proposal, after the activation of the SDRM by the debtor, all covered creditors would be formed into separate classes for the purpose of voting on a proposed debt restructuring. The sovereign would then formally propose the component draft agreements to each class, which would vote on them. The overall debt agreement would be considered adopted when approved by the stipulated supermajority (e.g., 75 per cent) of the outstanding principle of registered claims in each class. Also, new lending during the restructuring process would have repayment priority over defaulted claims, so as to facilitate essential credit flows from some private as well as official sources to the debtor government during the crisis period.

A new international legal mechanism, the Sovereign Debt Dispute Resolution Forum (SDDRF), would oversee the formation of the classes, validate the claims of individual creditors, and resolve disputes on the allocation of individual creditors to the classes and voting process. This should assure integrity to the process and help avoid ambiguities of language or interpretation. The SDRM would be established through an amendment to the IMF Articles of Agreement, which would bind all IMF member States, even those that had not endorsed the amendment per se.

Many issues in the design of SDRM are controversial. For example, consensus is yet to be reached on the scope of debt that would be covered. Under the proposal, credits from the IMF and multilateral development banks, official bilateral loans, as well as claims that are governed by domestic law would be excluded from the SDRM, although bilateral official credits are expected to continue to be treated in the Paris

Club mechanism. Consequently, only claims held by private creditors that either are governed by foreign law or are under the jurisdiction of foreign courts would be covered directly by the SDRM.

In addition, a feature thought to be essential when the proposal was originally made was dropped. This was the automatic but temporary “stay on litigation” by creditors seeking to recover their funds from a national court proceeding once the debtor defaulted and the SDRM process began. An automatic stay is a common part of corporate bankruptcy legislation, but in a context in which a court can impose obligations on the defaulting company that cannot be imposed on a sovereign state. Because of this, the stay was seen as a major abrogation of “creditor rights”. In addition, other mechanisms were suggested to have a comparable effect.

There are also concerns that the adoption of the SDRM through an amendment of the IMF Articles would put the mechanism too close to the IMF, which is a creditor itself as well as responsible for negotiating an adjustment programme with the government meant to leave the country with a sustainable debt situation at its end. The proposal’s authors have sought, in particular, to distance the SDDRF from the Fund, but critics see remaining links. In this regard, there have been proposals to instead create the SDRM or something like it under a stand-alone treaty, since the issue falls outside the Fund’s purposes and there is nothing in the operation of the mechanism negotiations themselves that need directly involve IMF.

Many emerging market countries fear that SDRM might not only raise their borrowing costs and impede market access, but also entail a loss of sovereignty, especially if bound by an IMF amendment for which they did not vote. In their turn, many private sector participants worry that the SDRM, by overriding existing bond contracts, would eliminate legal rights of bondholders. Most recently, the United States, whose former Treasury Secretary had been a major proponent of the SDRM approach, signalled that it had heard the fierce opposition to the proposal. It appears that work on the SDRM will not go forward at this time.

IV. Conclusion

The concern now is whether the contractual approach, which by design is not comprehensive, will suffice. It seems important to continue investigating mechanisms that incorporate or build on the contractual approach, while also taking up issues of how to assure the overall adequacy of negotiated debt relief packages in terms of the debtor country and its people, how to bring about comparability of treatment of creditors, how to enforce full participation of all creditors in each creditor class, and how to resolve debt crises more expeditiously than in the past. It seems important to look at non-treaty approaches, which could include potential international legal instruments, as well as voluntary mechanisms.