

**THE IMPLEMENTATION OF A
SOVEREIGN DEBT RESTRUCTURING MECHANISM
SHOULD BE A PRIORITY IN THE AGENDA OF
THE G7 AND THE IMF**

**By Carlos E. Alfaro
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The purpose of this paper is to stir the debate on the need for a sovereign debt restructuring mechanism that provides both emerging countries and the financial market with a legal framework within which to resolve debt problems in the future.

The need for such a framework is paramount to avoid the experiences of the 1990's that occurred in spite of the increasing involvement of the International Monetary Fund in prevention and surveillance policies. The case of Argentina clearly demonstrates that there is a gap that shows the costs to all parties involved – debtors, creditors, and people - as a result of the disorderly way (or lack of it) to resolve the multiple problems involved in that kind of situations.

During the last year and a half a healthy debate ensue between those in favor of a structural approach to solve these problems and a market-oriented approach. This debate not only should be intensified but lead to a solution in the short term. The markets have been disrupted and while solutions are adopted in the US and European private capital markets regulations – transparency, accountability and liability new regulations - nothing has been achieved yet at sovereign level.

Nevertheless, there is a better understanding of the issues involved and the consolidation of at least three positions – aside of leaving to the players in the market resolve the problems as they appear – which I will dealt with in this paper for the purposes of expediting the finding of a solution. This year of 2003 should not be one more year of debates but a year of choosing a mechanism and starting its implementation.

Historical Context

The 1990's sovereign financial markets were marked by what it was considered as a healthy new pool of funds to be tapped: the bond market. In the 1980's credits were primarily obtained from syndicated bank loans. It was a narrow market but at the same time it provided a more stable process in case of restructuring.

The bond market is beneficial for both an emerging country as well as for the investors and the intermediaries of the financial market. It reduces the risk of financial contagion so typical of the 1980's. The creditor base is wider and diversified.

But those benefits present also difficult problems in case of default. In the bond market there is an array of diverse instruments, under different jurisdictions, with diverse rules and sometimes opposing objectives. Workouts become more problematic to be achieved. In general, bonds do not contain supermajority clauses to change its original terms.

The IMF plays an important role both in the crisis and the solutions. Its role has shifted during the last years. Policy issues such as conditionality, ownership, accountability, prevention, disclosure, moral hazard and equal treatment are important and merit a separate debate. This paper will concentrate on what I believe are the most important alternative solutions proposed as of today. For other issues related to the subject matter, please refer to: a) "*Tightening IMF Macroeconomic Standards versus Growing Fiscal Indiscipline: Lessons to be learned from the crisis of the 90's*"; Carlos E. Alfaro, Paper presented at IBA's Fourth Biennial Conference on Project Finance in Washington DC, April, 2003; www.ibanet.org b) "*Private Debt Restructuring Strategy and Use of Statutory Creditor Stays*", Carlos E. Alfaro, published at December, 2002 31 edition of the Latin American Law and Business Report, World Executive Inc; www.wtexec.com; c) "*Argentina Inc. Beating Government To Restructuring Punch*", by Mike Esterl for Dow Jones International News on 4 December 2002, www.dowjones.com d) "*Sovereign Insolvency and Debt Restructuring: The Argentine case proves that a universal bankruptcy process should be put in place before the next crisis occurs*", Carlos E. Alfaro, published at Journal of Corporate Renewal, the monthly magazine of the Turnaround Management Association, July, 2003.

Debt Restructuring Proposals

I classify the alternatives in three: a Market or Decentralized Approach, a Statutory Approach or Formal Workout Mechanism and a Collective Action Clauses Two Step Approach, for the purposes of this paper.

The Market or Decentralized Approach is led by the US Treasury Department, mainly by its Undersecretary John Taylor's position papers in 2002. It is called a market approach because it establishes a process that does not require an authority to manage or supervise it and could vary from country to country and type of instruments involved. It primarily relies on the inclusion of collective contingency clauses in the bonds and bank loans.

The Statutory Approach falls within the universality principles of an insolvency procedure. It is based on a statutory implementation through the IMF, which will establish a legal framework with mandatory stay periods and mechanisms to resolve and vote on debt proposals. Anne Krueger, First Deputy Managing Director of the IMF, leads this approach.

The Two-step Approach has been proposed by Ed Bartholomew and Ernie Stern of JPMorgan Chase and basically proposes a voluntary exchange of existing bonds for instruments containing contingency clauses, using market incentives.

In essence, nothing indicates that the alternatives cannot be part of a process by which there is an orderly implementation of the three solutions step by step.

Market or decentralized Approach

1. Main Features

This approach advocates the introduction of collective action clauses in future bond issues. The idea of collective action clauses is not new. These kinds of clauses are already included in UK bonds. Furthermore, at different times the G7 and the IMF have encouraged its adoption. But perhaps John Taylor has been the authority that better articulated the idea.

The purpose of these clauses are to allow debtor to enter into an organized mechanism of restructuring where the rules are clear for all parties involved from the very beginning. It takes into account that debtors are sovereign nations and therefore a mechanism that obliges those nations to a process under the surveillance of supranational body is not a desired one at this stage in history:

Cooling-Off Period: At the moment a debtor nation announces the need to restructure its debt a cooling-off stay period is automatically applied. The extent of the period should be short (60 days as proposed by Taylor). During that period creditors will choose a representative or representatives to renegotiate the terms with the debtor.

Governing Rules: The bonds should include the legal framework that will control the process, such as the powers of the creditor's representative – including litigation -, debtor's disclosure obligations and reporting duties of the representative to the creditors. Within this framework rules should be included to aggregate claims for voting purposes among the different classes of bonds.

Supermajority Voting Clause: The creditor's representative should negotiate according to the instructions of the majority of the bondholders and this majority should agree on the final terms of the restructuring. Such majority is considered that it should be in the 75% of the total number of bondholders.

2. Potential Problems

As any voluntary program among members with different economic levels and structural characteristics, as well as financial vulnerabilities or natural resources, including collective action clauses by certain countries may not be favorably accepted. It may be an indication of a lesser quality bond or of the concern of the country with the viability of its own program. Unless, there is an agreement for its generalized implementation by the majority of the developed and emerging countries, the market will probably penalize the first countries with lesser credit rates.

Incentives or penalties will be needed for the success of the proposal, – the IMF could provide better terms to complying countries or withhold supporting programs - in which case the market approach will lose its allure when compared with the structural approach. The IMF will become a prisoner of this policy and will be obliged to provide assistance to any country that adopts the clauses.

The approach does not solve the problem of different classes of creditors and how to coordinate their actions – syndicated loans versus bondholder's claims – Again the market approach proposes a non-market approach to solve the problem: an arbitration process. Even then, the fact that the existing debt may be subject to different laws and jurisdictions presents a problem.

Statutory Approach

1. Main Features

This approach entails two legal foundations: the existence of a treaty and a supra national procedure. In the Anne Kruger proposal both are met without the need of a new treaty, as it is the belief that it could be instrumented within the provisions of the IMF treaty agreement. The IMF will act as a controller of the process. Basically it will involve:

A standstill or stay Period: Debtor will request the IMF a temporary standstill. No legal actions could be initiated during this period. Pre-agreed measures with the IMF will be put in place to avoid capital flight and keep the level of reserves under an IMF-supported adjustment program. The stand still period could be extended with the agreement of the creditors (supermajority).

Debtor Limitations: Debtor will be limited in the actions to be taken during the period of negotiations – for example granting preferences to certain creditors over others, implementing policies contrary to creditors rights or radical change of policies.

New Financing Incentives Mechanisms: To encourage new private lending by giving certain seniority to fresh financing over existing debt. It will be in the interest of the creditors that debtor could continue to engage in business and trade activities.

A Procedure to ensure an Orderly Process: A process for the verification of claims, voting rules and adjudication of disputes should be established. The overseeing role of the IMF will be relevant in this case.

Bound Rules: Decisions will be taken by the vote of a super-majority of creditors at all levels. By the same token, minority creditors will be barred from initiating any action for the purposes of requesting an injunction or filing claims under their original debt agreements.

The benefits of this Statutory Approach for its advocates resides in the fact that it will be applicable to all members once it has been implemented by contrast to the market approach that depends on the individual acceptance by debtors nations. The latter could be a long process and in some cases never materialize. Uniformity of application over all different debt instruments is another advantage cited in the favor of this solution. Likewise, I will eliminate the problem of dealing with diverse jurisdictions. The assurance of the IMF supervision of the

process and the economic plans implemented by the debtor during the process is another value. Furthermore, the existence of one forum to resolve disputes secures continuity and predictability.

2. Potential problems

The system can encourage debtors to misuse it. Defaulting will no longer be considered such a dramatic event. Debtors may also take advantage of the process and it will be more difficult to get better terms. In a private voluntary insolvency procedure there is always the possibility that creditors decide that they will be better off liquidating the company or finding a potential buyer. This alternative is absent in a sovereign debt restructuring insolvency mechanism.

The support of the IMF becomes essential to the system and it will be unavoidable for the IMF to provide financial assistance.

It is necessary to categorize creditors in classes for voting purposes. These categories will be difficult to be included in the IMF agreement. They will have to be worked out in a case- by- case basis. If each class shall have veto power, the possibility of a hold out increases.

It does not resolve the problem of domestic debt, which will still be subject to local law and jurisdiction and the cases of country-to-country debt, which will continue to be dealt under the Paris Club.

The role of an adjudication body could also present some objections. Questions of independence, conflict of laws or extent of its role and powers, have been raised.

The Two Step Approach

1. Main Features

It is a variety of the market approach and one of its main purposes is to reduce the problem of dealing with a variety of bonds issues with diverse provisions and under different jurisdictions.

When facing financial difficulties and the prospect of a debt restructuring a debtor country may use its resources to offer incentives to bondholders to accept an exchange of the existing debt for new debt instruments called Interim Debt Claims – IDCs –

The IDCs may also include “exit consent clauses” – i.e.: Ecuador included in its restructuring of 1999 these “exit consent” provisions, being the first country to rely on this technique. The exist consent clauses consists in a provision in the new bond that allows a majority to bind a minority with respect to amendments to bond clauses unrelated to payments. Under the exchange offer, bondholders who accept the exchange usually vote in favor of a list of amendments, making the existing bond less attractive. As a result, even if the bondholders who refused to accept the “exchange offer” become a majority of the original bond, they cannot reverse the amendments without the consent of sovereigns.

“Exit consents” are a commonplace feature in the U.S domestic bond markets and have generally been upheld, in the believe that their legality is essentially a mater of bond contract interpretation.

The Market Approach deals with the future. The Two Step Approach deals with present situations and the already existent stock of bonds or debt of a country. It harmonizes the rules of engagement facilitating the process of restructuring.

It seems that this approach could be better implemented when a country has already defaulted or about to collapse. It also addresses matter of ownership policy by allowing the country to implement its own structural and fiscal program. The market will freely signal its viability.

2. Potential problems

As the market will decide the fate of this plan, the penalties of a failure to achieve a successful exchange are great risk to run, but on the other hand countries will be forced to adopt very responsible economic and fiscal policies in advance to its implementation.

A typical effective incentive in these exchanges is a cash payment. Therefore, the main problem in this approach is from where the country will get the resources to implement the offer. Local investors may be penalized in favor of foreign creditors.

Another problem that this approach does not resolve is the possibility of holdouts. It is vulnerable to speculative investors.

This proposal will better apply to cases in which the crisis originated in overall market conditions, rather than in domestic policies.

Therefore, is an approach to be used in specific cases.

Conclusions

The debate should accelerate in order to reach a minimum consensus. Both the structural as well as the market approach recognize that certain features of the other are complementary and necessary for their systems to work – i.e.: collective action clauses and arbitration procedure by an independent body respectively -

A gradual implementation of the two-step approach, with an effort to reach a consensus across nations of the need to adopt collective action clauses with the implementation of a partial role of the IMF as an arbitrator in certain matters – integrity of the process and resolution of disputes – seems an attractive objective to be pursued.

All the approaches need to be refined. More detailed proposals should be put to discussion. The temptation to delay this work could prove fatal in the present state of affairs of the world economy. We need to use the time constructively to start building a solution to the recurrent financial crisis.

The case of Argentina at the beginning of this century is a clear example of the disorder that the lack of clear rules to deal with a default situation could bring to a country and the unnecessary painful consequences for all parties involved – creditors, pensioners, workers, families, investors – The Argentine authorities tried unsuccessfully different policies to solve the problem during a long period of time. If an orderly process would have been in place, this time would have not been wasted and the damages would have been contained.

A process that could provide predictability to the market is of the essence. It will better protect the value of the different assets involved that could be used for structuring a payment proposal. The country and its people will also benefit as the local economy will not be disrupted in the extent that they have been disrupted in the recent cases of Ecuador and Argentina.

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