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Center on Global Economic Governance

Initiative *for* Policy Dialogue

“Frameworks For Sovereign Debt Restructuring”

IPD-CIGI-CGEG Policy Brief¹

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1. There is a new world in sovereign debt restructuring. Three critical factors: (a) move from bank to market finance makes debt restructuring more difficult; (b) increased use of CDSs creates perverse incentives that hurt efficiency in restructurings; and (c) recent US court decision on Argentina’s case makes debt restructuring difficult--or impossible.
2. Though there are "quick-fixes" that would ameliorate problems (such as restoring sovereign immunity), these do not address the underlying problems in sovereign debt restructuring (discussed below). The view that Argentina is the exception, and therefore recent court decisions are of little relevance for the functioning of the market, is at best unsettled, and probably wrong. (What was unusual about Argentina was that it bargained hard; because it would not give in to creditor demands, markets interpreted that it bargained in bad faith.)
3. Poorly designed arrangements for resolving sovereign debt problems can lead to inefficiencies and inequities--and to Pareto inferior outcomes. Delays in restructuring can be very costly. Insufficiently deep restructuring can force the economy through multiple crises and restructurings--at a high cost. An inadequate restructuring framework increases the costs of borrowing and the benefits of lending, leading to sub-optimal levels of credit flows. Restructurings that impose excessive burdens on the borrower may lead to insufficient due diligence on the part of lenders.

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4. Any framework for sovereign debt restructuring has to take account of the primacy of the functions of the state, its obligations to its citizens, and the "social contract" the state has with its citizens. Claimants on the state include not only the formal creditors, but also informal claimants, such as old age pensioners. Poorly designed arrangements will simply encourage governments to convert informal claimants into less flexible formal contracts.

5. There seems to be considerable scope for improving private debt contracts, by including better designed collective action clauses (the failure of the last round of collective action clauses is a warning that it may not be that easy to do so), clearer statements concerning the meaning of the *pari passu* clause (though the "novel" interpretation of Judge Griesa is a warning that this may not be as easy as one hoped), the incorporation of Champerty Defense clauses, and other provisions relating to lending in arrears and stays. The recent ICMA's proposals (also supported by the IMF) for aggregation of collective action clauses and for clarifying the meaning of *pari passu* are improvements over the old terms, but are not sufficient to solve a variety of problems faced in sovereign debt restructurings (described below).

It was not clear the extent to which it was possible to include provisions analogous to US Chapter 9 into debt contracts.

6. The background legal framework is critical in determining the nature of the bargaining process and outcomes. Judge Griesa's decision and New York State's legislation eliminating the Champerty defense are examples of changes in legal frameworks with possibly profound consequences (and interestingly, representing major changes in property rights, occurring retroactively to the issuance of the bonds, and in that sense, providing what some participants thought of as unjust enrichment for bondholders.)

7. IMF's lending policy is also critical in determining the nature of the bargaining process and outcomes. The IMF's policies can be, *de facto*, a full bailout for the private lenders, even for loans made to private borrowers, as debts are socialized. In some cases, the re-profiling of debt provides the opportunity of short term creditors to get repaid. There is, in effect, a redistribution between short term and long term creditors; the bail-out allows the short term creditors to escape while the long term creditors have to take a bigger haircut than they otherwise would have had. IMF loans have effectively preferred creditor status, and in the subsequent restructuring, there is as a result a larger haircut for long term creditors than there would have been in the event of an immediate "bankruptcy" proceeding. In the case of heavily indebted countries with large primary deficits, the IMF can force the debtor to agree to terms that are very favorable to the creditors. On the other hand, they can force a bail-in of the private sector--of existing creditors.

8. IMF's lending policy--even were it able to judge accurately debt sustainability and to engage in debt reprofiling, a proposition that is challenged by the recent IMF's flawed output growth forecasts for countries in distress-- is not enough to resolve the problems posed by debt burdens beyond the country's ability to pay. Even IMF restructuring of this limited form faces some difficult problems that need further discussion: What interest rate should be used? Should it be the high interest rate that reflected the market's judgment of the risk of default *in the absence of an IMF restructuring*? But the restructuring itself should resolve some aspects of that risk--indeed, going forward, if the IMF has done

its job so that the reprofiling ensures debt sustainability, there is no risk of default; hence a very low interest should be used. But then, will creditors accept the reprofiling? What is the nature of the bargaining relationship between creditors and the IMF--especially if the Executive Directors in the IMF disproportionately represent creditor interests?

More generally, many discussions of debt sustainability miss the key issue of the stochastic nature of the economic environment. A good debt re-profiling simply increases the probability that further assistance will not be needed, that there will not be a later crisis. One is always assessing trade-offs at the margin: the cost of a deeper re-reprofiling versus the benefit of a slightly lower probability of a crisis down the line.

The IMF can also play a catalytic role in encouraging, for instance, the use of GDP bonds.

9. CDS's --especially when they are not transparent--have changed in a fundamental way the nature of debt resolution between creditors and debtors. Creditors may or may not have an interest in the smooth resolution of the problem. They could be better off in the event of a default than if there is a debt restructuring. There is no way to ascertain whether they are bargaining in good faith. While CDSs held by those with no insurable interest are an invitation to mischief--and proposals to ban them should be given serious consideration--the problem would remain that the economic interests of those at the bargaining table may be markedly different from what their ownership claims in bonds would suggest.

10. Collective action clauses, while they might work well if there were a single class of bondholders, face inherent problems in aggregation across classes. A simple supermajority rule could lead to a situation where junior creditors vote to have themselves treated equally with more senior creditors. These coordination problems are increased further when there are bonds written in different currencies and in different jurisdictions, as establishing priority of claims could be a daunting task, with multiple contradictions. And how are informal claimants (pensioners) to be aggregated with formal claimants? There was a consensus that none of the proposals for addressing the aggregation do so in a fair and effective way.

11. Creditor committees may enhance support for consensual deals, reducing the risk of holdout behavior. However, they can also increase collusive behavior among creditors.

12. There are inter-debtor coordination problems that may lead to a suboptimal global equilibrium. In a context of heterogeneous debtors and imperfect information, each of them might choose to issue debt under "tough" jurisdictions to signal that the probability of default is low. Then, the resulting equilibrium would feature a situation where debt restructuring would be too difficult.

13. Even with the best design of collective action clauses, the described coordination problems could not be fully solved. Besides, there would be a difficult problem posed by the hundreds of billions of dollars of existing debt without collective action clauses and with existing *pari passu* clauses. It might be desirable to encourage voluntary exchanges with debt contracts with such clauses, but what is to be

done about hold-outs? And if there are hold-outs, why would others give up their rights? The only way out appears to be a new global framework.

14. Because of the problems noted above, the private contractual approach is not adequate. These problems have been recognized before the recent events (e.g. by the UN Commission of Experts and by the IMF), but recent events have made the case even more compelling. What is required is a new global Framework for Sovereign Debt Restructuring. (If a private contractual approach were adequate, then why has no country domestically opted for this? Indeed, a central piece of IMF advice to countries is that they *need* a bankruptcy code. As we noted in point 4, sovereign debt restructurings are even more difficult, because of the ambiguity concerning claimants.) Possible designs of such a global Framework for Sovereign Debt Restructurings are briefly described in the Report of the UN Commission of Experts.

15. There are, however, difficult political problems in the adoption of a legally binding framework, analogous to the intense political conflicts within some countries in the design of their own bankruptcy codes (which itself is testimony to the fact that such frameworks *are* relevant.) Here, the usual conflicts are compounded by conflicts of interest within countries and the democratic deficits that exist even in the seemingly strongest democracies. While it has been argued persuasively that some of the reforms discussed above (such as clarifications on the *pari passu* clause and the restoration of variants of the Champerty defense) would be in the broader interests of the US bond market, it appears that the position of the US may be overly influenced by a very small fraction of the US financial market, the vulture funds. The geo-political difficulties are being reflected in the reported opposition of the US Treasury to UN efforts to create a Framework for Sovereign Debt Restructuring, even though that initiative had the overwhelming support of the General Assembly, including all developing countries with one abstention (Mexico).

16. Short of a global agreement, national legislation may go some way to improving matters. They could incorporate variants of the Champerty defense, impose conditions similar to Chapter 9 of the US bankruptcy code (giving voice to claimants other than the formal creditors), insist on transparency concerning holdings of CDSs by all creditors participating in the restructuring discussion (and adjust voting rights, if there is a CAC, accordingly), clarify the meaning of *pari passu* clauses. National legislation cannot resolve conflicts arising when bonds have been issued in different jurisdictions. This requires a global framework.

17. Even if a formal global agreement among all countries is not feasible, there is scope for an international commission to help set norms and mediate among parties, to provide independent assessments of debt sustainability and the legitimacy of various formal and informal claims, and to mediate among the parties. It is possible that such a "soft law" approach could evolve into the more formal framework called for in par. 14.