INTERNATIONAL MONETARY FUND

Sovereign Debt Restructuring Mechanism—Further Considerations

Prepared by the International Capital Markets, Legal, and
Policy Development and Review Departments

In consultation with other Departments

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I. Introduction

1. The Fund is considering two approaches for securing a more orderly and transparent framework for sovereign debt restructuring: a contractual approach aimed at promoting the use of contractual provisions to facilitate collective action by creditors holding international sovereign bonds, and a statutory approach, which would enable a sovereign debtor and a super-majority of creditors to reach an agreement binding all creditors across the aggregated debts of the sovereign, paying due regard to the seniority of claims. The International Financial and Monetary Committee (IMFC) at the Spring Meetings[1] viewed these two approaches as complementary and self-reinforcing, and encouraged the Fund to continue to examine the legal, institutional and procedural aspects of both. Issues related to the design of contractual provisions and how the Fund and other parties could strengthen incentives for the use of collective action clauses in international sovereign bonds were discussed in two recent papers.[2] The present paper focuses on several issues that would need to be addressed to make the statutory approach operational. It builds on previous SDRM papers and Board discussions.[3]

2. The paper is organized as follows. Section II of the paper revisits the rationale for the Sovereign Debt Restructuring Mechanism (SDRM) and distills a number of its key features.[4] Section III discusses the scope of debt to be covered under the SDRM, with particular focus on the treatment of domestic debt and debt owed to bilateral official creditors. Section IV gives further consideration to the role, powers, and composition of the Sovereign Debt Dispute Resolution Forum that would be established under the SDRM. Section V suggests issues for discussion.

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[1] Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, April 20, 2002.

[2] See: Collective Action Clauses in Sovereign Bond Contracts—Encouraging Greater Use, SM/02/175 (6/7/02), and The Design and Enforceability of Collective Action Clauses, SM/02/173 (6/7/02).

[3] Concluding Remarks by the Acting Chair on Sovereign Debt Restructuring Mechanism—Further Reflections and Future Work, BUFF/02/39 (3/14/02), Statement by the First Deputy Managing Director on Sovereign Debt Restructuring Mechanism, BUFF/02/30 (4/1/02), Sovereign Debt Restructuring Mechanism—Further Reflections and Future Work, FO/DIS/02/18 (2/14/02), and A New Approach to Sovereign Debt Restructuring—Preliminary Considerations, FO/DIS/01/151 (11/30/01).

[4] A discussion of issues associated with the possible application of an SDRM to the liabilities of nonsovereign debtors is beyond the scope of this paper.

II. THE RATIONALE FOR THE SDRM

3. **In extreme cases, members may have unsustainable debt burdens.** That is to say, members could confront situations in which there is no feasible set of sustainable macroeconomic polices that would allow the member to resolve the current crisis and regain medium-term viability without a significant reduction in the net present value of the sovereign's debt. In such cases, countries may have gone to extraordinary lengths to avoid a restructuring before finally recognizing the need for a debt adjustment. In any event, a debt restructuring would be intended to achieve a number of objectives, including:

- Reducing the overall debt to a level consistent with a return to sustainability.
- Establishing a debt structure and debt-service profile that would ensure that exposure to rollover risks is manageable, and that exposure to market risks, such as interest rate and exchange rate risks, is unlikely to undermine financial stability and progress toward sustainable growth.
- Engineering a structure of domestic debt that supports key policy objectives, notably the efficient operation of the domestic banking system; and a structure of external debt that is likely to establish benchmark spreads that could facilitate a return to international capital markets.

4. **Members with unsustainable debt burdens and a diffuse group of creditors may face substantial difficulties in reaching rapid agreement with their creditors on a restructuring that would restore sustainability**. Collective action difficulties, that create incentives for individual creditors to hold out in the hope of obtaining for more favorable terms, complicate the task of achieving broad participation in restructurings that may serve the interests of both the debtor and creditors as a group. By the same token, difficulties of achieving adequate intercreditor equity may also inhibit creditors from accepting proposed restructurings, thereby prolonging the process.

5. **Recent developments in capital markets have amplified these difficulties.** The last 15 years have witnessed a shift away from syndicated commercial bank lending toward a variety of tradable financial instruments issued in a number of legal jurisdictions that are held by a diffuse and broad base of creditors. In many respects, this is a positive development, as it has broadened the investor base for financing emerging market sovereigns, and has facilitated the diversification and management of risk. However, the diversity of claims and interests could generate significant coordination problems across claims and claimants in cases where a sovereign decides to seek the restructuring of its debt.[5] The narrow range of debt instruments containing contractual provisions that could facilitate a restructuring may

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[5] End-2001 data suggest that a substantial majority of international sovereign bonds that are currently outstanding do not contain collective action clauses.

provide only limited help in achieving rapid agreement in cases in which the member has substantial indebtedness that does not include such provisions.[6] (Moreover, the effectiveness of contractual provisions in individual instruments would be limited to the extent that potential holdout creditors are able to acquire controlling interests in individual bond issues.)

6. **Against this background, there is now an increasing recognition in both the official sector and private markets that the current process for restructuring the debt of a sovereign needs to be improved.** The current process imposes undue costs both to the debtor country and its creditors, because it is prolonged and unpredictable. It may also risk contributing to contagion, with associated costs and risks for the stability of the international financial system.

- **Costs to debtors are magnified by delaying an unavoidable debt restructuring.** Even when it becomes clear that there is no feasible set of adjustment policies to resolve a country's financial crisis unless accompanied by debt restructuring, policymakers are reluctant to embark on such a process.[7] The delay, however, magnifies the costs, including in terms of reserve losses and economic dislocation, leaving the country in a worse situation when the default is announced.

- **The interests of most creditors are damaged by difficulties in securing collective action for an early agreement on sovereign debt restructuring**. The value of their claims would be better preserved if the debtor acted at an early stage and thereby helped to preserve the economic value of financial and nonfinancial corporations, and the capacity of the economy to generate tax revenue. Asset values would also be better preserved if uncertainty over recovery values were to be reduced. Such uncertainty may exacerbate risks of a rush to sell, which would depress secondary market prices and impose large mark-to-market losses, and make it very difficult to rollover maturing claims. Creditors would also benefit from measures to lower the risk that holdout investors might imperil future payments on restructured debts and receive better treatment than cooperative creditors.

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[6] Even widespread adoption of collective action clauses allowing issue-by-issue majority voting might not resolve coordination problems in cases where a multitude of outstanding debt instruments are dispersed across different creditor groups.

[7] As highlighted in a review of recent country experience, a default or a restructuring in the shadow of default may involve declining real incomes, sharply curtailed private investment, financial sector difficulties, and drainage of external reserves in the attempt to stem pressures from capital outflows. The impact on the domestic economy and the links between sovereign debt restructurings, currency crises and banking crises in recent cases were analyzed in Sovereign Debt Restructurings and the Domestic Economy—Experience in Four Recent Cases, SM/02/67 (2/21/02).

7. **The key challenge is to establish a restructuring mechanism that resolves collective action problems while creating appropriate incentives for a sovereign and its creditors to reach rapid agreement on a restructuring that preserves asset values and facilitates a return to medium-term viability.** The sovereign debt restructuring mechanism (SDRM) aims at creating a framework for a debtor with unsustainable debts to approach its creditors promptly, and preferably before interrupting debt-service payments, while avoiding any incentive for countries with sustainable debt to resort to this mechanism rather than make the necessary adjustments to their economic policies.

8. **The central feature of the SDRM would be the ability to bind all creditors to a restructuring agreement that has been accepted by a qualified majority (*majority restructuring*).** To address problems that arise from the diversity of the creditor community and the variety of claims, this mechanism would have broad coverage of various forms of a sovereign's indebtedness and would aggregate claims for voting purposes, while paying due regard to the distinct nature of the claims of different creditors.[8] These characteristics distinguish the SDRM from the majority restructuring provisions found in collective action clauses that bind bondholders only within the same bond issue.

9. Provisions that allow for ***majority restructuring*** would be most effective if complemented by three additional features:

- ***Stay on creditor enforcement*****—**An SDRM would provide the debtor with temporary legal protection from creditor litigation after a suspension of payments, as long as the debtor obtained the agreement of a super-majority of creditors.

- ***Protection of creditor interests*****—**An SDRM would give creditors assurances that the debtor would act responsibly and refrain from taking specific measures that would prejudice their interests during the period of stay. In this context, the sovereign would be expected not to make payments to nonpriority creditors to avoid the dissipation of resources that could be used to service the claims of all relevant creditors.[9] In addition, the debtor's close involvement with the Fund would provide assurances that the debtor was adopting and implementing appropriate economic policies.

- ***Priority financing*****—**An SDRM would aim to facilitate new private financing by providing an assurance (pursuant to a decision by a qualified majority of creditors) that the provision of new money in support of the member's program extended during the stay would be senior to all preexisting indebtedness.

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[8] Issues connected with domestic debt of the sovereign are discussed in the next section.

[9] Sanctions could include lifting the stay, and potentially the loss of access to Fund resources.

10. **The sovereign debtor would have the exclusive authority to decide whether and when to activate the SDRM.** From the perspective of the sovereign, therefore, restructuring under the SDRM would be voluntary and would be used in those circumstances where the sovereign makes the judgment that the features of the SDRM would enhance its capacity to restructure unsustainable debt rapidly and in manner that limits economic dislocation. The sovereign could also decide to terminate the SDRM process if other procedures for restructuring its debt appeared preferable.

11. **Once activated, key decisions under the SDRM would be left to the debtor and a super-majority of its creditors.** This would include decisions about the terms of the restructuring, legal protection for the sovereign (activation and maintenance of the stay), and the provision of seniority for new private financing over pre-existing indebtedness. The official community through an amendment of the Fund's Articles and, where necessary, changes to domestic legislation would provide the statutory legal basis to make this agreement binding on all relevant creditors. Together with the dispute resolution forum discussed below, this would resolve problems currently arising from the absence of legal uniformity across different legal jurisdictions. During the restructuring process, the Fund would continue to rely on its existing financing power to provide support for an effective economic adjustment program and create the incentives, including through its lending into arrears policy, for the relevant parties to use the mechanism appropriately.

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Next steps in developing an SDRM

12. **In earlier discussions, Executive Directors highlighted a number of issues in the design of the SDRM that would need to be addressed to make the statutory approach operational.**[10] Specifically, issues concerning the scope of debt that would be covered by the SDRM, and the design features and operational modalities of the dispute resolution forum that would, among things, safeguard the integrity of the voting process. The remainder of this paper carries forward the discussion on these issues. Other issues raised by Directors could be addressed in subsequent papers. These include the treatment of nonsovereign debt and, in that context, the role of exchange controls, including the applicability of Article VIII, 2(b) of the Fund's Articles; the provision of senior private financing, which raises questions about the relative standing of senior private financing and financing from preferred creditors: the protection of creditor interests during the stay; and the implications of an SDRM for the HIPC process.

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[10] See Concluding Remarks by the Acting Chair on Sovereign Debt Restructuring Mechanism—Further Reflections and Future Work—Executive Board Seminar 02/03 and 02/4, 3/8/02, BUFF/02/39 (3/14/02).

13. **The scope of debt that would be covered under the SDRM is discussed in Section III**. It is likely that a debt restructuring by a sovereign with an unsustainable debt burden will need to be comprehensive both in order to achieve a reduction in debt service of a sufficient magnitude to restore sustainability, and to achieve adequate intercreditor equity to garner broad support for the restructuring. There are questions, however, whether it is necessary to include all categories of debt under the SDRM to ensure that they are restructured in an effective manner. In this context, the paper provides a discussion of the treatment of both domestic debt and the claims of official bilateral creditors.

14. **Section IV gives further consideration to the role, powers and composition of the Sovereign Dispute Resolution Forum that would be established under the SDRM**. Under a framework where the claims of creditors are aggregated for voting purposes, it is necessary to establish a dispute resolution process that prevents manipulation of the voting process that may arise through, for example, the creation of fictitious claims or the exercise by the sovereign of undue influence over certain groups of creditors. One of the advantages of a statutory framework is that it ensures that this process is a unified one. Moreover, it avoids the need to address all of these risks *ex ante* through contract, thereby providing adequate flexibility to address the evolution of capital markets.

III. The Scope of Sovereign Debt Under an SDRM

15. **A central issue to the design of the SDRM is the scope of debt it will cover. This section focuses on how the SDRM can most effectively coordinate the restructuring of three different types of sovereign debts: external debt to private creditors, domestic debt, and debt owed to official bilateral creditors.** Other aspects of this subject, including the relative treatment of secured and unsecured claims, will be the subject of a future paper.[11] As noted above, this discussion here is limited to the restructuring of sovereign debt; issues concerning the application of the SDRM to unsustainable debt burdens of nonsovereign borrowers (including, for example, the possible need to resort to exchange controls) are beyond the scope of this paper.

[11] Another issue to be discussed in a future paper will be the extent to which the SDRM would be limited to debt that arises from the borrowing money and suppliers credits; i.e., it would exclude claims that arise from the failure to pay for the performance of services (e.g., arrears on payments to government employees).

A. General Considerations

The scope of debt to be restructured

16. **The scope of sovereign debt that must be covered by a restructuring is likely to need to be comprehensive in order to achieve a reduction in the debt and debt-service burden of a sufficient magnitude to restore sustainability.** A comprehensive restructuring may also be needed to modify the maturity profile (so as to limit exposure to rollover risk), as well as to limit the sovereign's exposure to market risks, such as exchange rate and interest rate risks. Creditors that are being asked to provide debt and debt-service reduction will want other creditors to make broadly similar contributions to the restoration of sustainability. They may also require reductions in the sovereign's exposure to rollover and market risks, even for debts that are to be excluded from debt and debt-service reduction, in order to reduce the sovereign's vulnerability to future crises, and thereby increase the assurance that the restructured claims would be serviced on a timely basis.

17. **As will be discussed further below, there may be circumstances in which it would be appropriate to exclude certain categories of debt from a restructuring, to the extent that such an exclusion could complement other policies designed to support a return to sustainable growth.** While creditors will generally want to ensure intercreditor equity, in specific cases they are likely to accept some differentiation in the treatment of individual claims, to the extent that this serves to limit the extent of economic dislocation and helps the sovereign generate resources for debt service.

18. **In the final analysis, the scope of debt to be restructured will be determined by the debtor, though its choices will be influenced by willingness of the Fund to support a program based on such a restructuring.** The debtor's choices will take into account the availability of official financing, the resources that it has available for debt service, and the desirability of preserving access to specific types of financing, such as trade credits. It will also need to take account of the views of private creditors, to the extent that such creditors indicate that their willingness to participate in a restructuring and to vote to extend the temporary stay will be influenced by the treatment of specific instruments. In a Fund-supported program, the scope of the domestic and external restructuring selected by the debtor and the package of macroeconomic and structural policies would need to be consistent with a return to fiscal sustainability, external balance, and monetary stability. For instance, the sovereign's capacity to continue to service local currency claims even in periods of acute fiscal stress and severe pressure on the official reserves may be constrained by a monetary program, which limits its ability to resort to monetary financing.[12] The program inflation target and exchange rate policy will also set the parameters for any reduction in the value of

[12] The choice between restructuring and monetization, of course, will be a function of the program's assumption about rollover rates—and terms—on domestic-currency denominated debt.

local currency debt instruments engineered through inflation and exchange rate changes. The program will incorporate, when relevant, decisions about the best way to protect the banking system in the context of a comprehensive debt restructuring. Reserve floors may similarly affect the country's ability to service foreign-currency denominated debts. Of course, options for the program may be limited by choices that the debtor made prior to engaging with the Fund.

The design of the SDRM

19. **The broad scope of the debt that may need to be covered by a restructuring, and the diversity of instruments and creditors, highlights the need to allow flexibility in the design of the SDRM.** A legal framework that creates the necessary incentives for a rapid restructuring must allow sufficiently broad coverage to overcome the relevant collective action problems. But it must also pay due regard to the reality that not all creditors are similarly situated. Furthermore, while a comprehensive restructuring will often be most effectively achieved when all claims are adjusted simultaneously, there may be circumstances where a sequenced approach will be necessary. Achieving an appropriate balance between predictability and flexibility in this regard is central to any discussion of the SDRM's treatment of various types of debt.

20. **How can the SDRM most effectively balance the above objectives? The broader the scope of debt to be covered under the SDRM, the greater the need to adequately differentiate between various types of claims.** Such differentiation can be most effectively achieved through a framework that provides for ***creditor classification*** and, as will be discussed below, this framework could be implemented in different ways. As a general matter, the SDRM becomes simpler as the scope of debt to be covered is narrowed. On the other hand, if ***categories of debt are excluded*** from the scope of the SDRM, the challenge will establish an alternative procedure so that this debt can still be effectively restructured in a manner that addresses collective action problems and concerns regarding intercreditor equity.

(A) Classifying claims

21. **Addressing the fact that creditors have different types of claims on the sovereign and are not always similarly situated** is of particular importance in circumstances where the claims of creditors are aggregated for voting purposes. Otherwise, there is a risk that a minority of creditors with a certain type of claim will be unfairly treated by a qualified majority of creditors holding different claims. While this risk is most obvious in cases where the minority have legal seniority over the majority (e.g., where a majority of unsecured creditors could vote on restructuring terms that effectively strip the collateral from a minority of secured creditors), it may also arise in other contexts. Separately, there may also be circumstances where creditors, although they all hold claims of the same seniority, have different economic interests from each other. In such circumstances, agreement on the overall restructuring may be easier if certain groups of creditors receive restructuring terms that are different from those offered to other creditors. The preferences of official bilateral creditors

and private creditors, for example, often differ, as each is subject to different constraints. There also may be large differences in preferences among private creditors. For example, commercial banks (particularly domestic commercial banks) may be willing to accept terms that would not be acceptable to bondholders.

22. **As a means of addressing this issue, and drawing upon practices that have been developed in nonsovereign insolvency laws, it is possible to create separate classes of creditors.** Under such an approach, support by a qualified majority of creditors in each class would be required to approve the restructuring terms offered to all classes. While votes would be aggregated across instruments—thereby greatly reducing the leverage of holdouts—there would be no aggregation of votes across different classes. However, since all classes would be required to approve the overall restructuring, each creditor class would have effective veto power over the terms offered to other classes. Creditors would only have the right to vote (and thereby be in a position to exercise a veto) if their claims were being restructured under the SDRM. Finally, while all creditors within the same class would need to receive the same restructuring terms (or menu of terms), treatment of creditors across classes could be different.[13]

23. **There are two ways in which a classification framework can be implemented.**

- A first approach would be to pre-specify all creditor classes in the text of the treaty establishing the SDRM. Under this approach, the classes to be created would be limited to those where it is possible to make general, ex ante judgments regarding the relative seniority of claims (e.g., secured vs. unsecured claims) or the varying economic interests of different types of creditors (e.g., private creditors vs. official bilateral creditors).

- A second approach would be to pre-specify certain classes in the text of the treaty,[14] but also allow for the creation of additional classes in individual cases. Drawing a parallel with the nonsovereign context, the text would establish the general criterion to be used for determining whether such additional classes would be necessary. This criterion could provide, for example, that creditors who are not similarly situated (taking into account the nature of their claims and economic interests) should be placed in different classes. While the classification (or lack thereof) would be originally proposed by the debtor, creditors would have the right to challenge whether such a classification was justified. Such disputes would be resolved by the Sovereign

[13] While creditors within the same class could be offered a menu of options, the options would need to be sufficiently similar that the eventual choices made by each member in the class would not materially affect the viability of the overall restructuring.

[14] The text would form part of the amendment to the Fund's Articles of Agreement.

Debt Restructuring Forum, taking into consideration the general criteria set forth in the text of the treaty and the specific features of the case in question.

While this second approach would involve the Sovereign Debt Dispute Resolution Forum (SDDRF) playing a more active role, it would enhance the SDRM's flexibility and enable it to adapt to the evolution of the capital markets.

(B) Excluding claims

24. **Would it be possible to exclude certain categories of claims from the SDRM?** In many circumstances, a broad and comprehensive restructuring will be necessary for the restoration of sustainability, and it is necessary that the authorities in the debtor country have access to tools that allow them to successfully restructure a wide range of debts. For some types of debt, however, the sovereign may already have the tools at its disposal to overcome a range of obstacles to a successful restructuring. As a consequence, it may be possible to design the SDRM in a manner that excluded some categories of claims without jeopardizing the authorities' ability to restructure those claims.

25. **However, it would be important not to exclude from the SDRM those claims where the SDRM provides the needed tools to allow the sovereign to better overcome collective action difficulties.** In particular, the SDRM would need to be designed so that claims held by private creditors that are either governed by foreign law or subject to the jurisdiction of foreign courts would always be included. As will be discussed below, such creditors are most capable of exercising their legal leverage in a manner that can undermine the restructuring process. The aggregated voting provisions of the SDRM are needed to resolve collective action problems among these creditors that arise because of this leverage. However, even if other types of claims are excluded from the coverage of the SDRM, private creditors holding claims governed by foreign law are likely to insist that—as a condition for approving the terms of their own restructuring through the SDRM—they be given some assurances that the restructuring of other types of debt occur in a manner that provides for adequate intercreditor equity.

26. **Although it would be necessary to specify in the text of the treaty whether a claim is included within the scope of the SDRM, it may not always be necessary to activate the SDRM in order to restructure such claims.** In circumstances where a sovereign forms the view that only a particular category of debt needs to be restructured and this can be effectively achieved without the assistance of the SDRM (e.g., because collective action problems are minimal), it could restructure these claims without having to activate the SDRM. In other cases, it might restructure some claims rapidly outside of the SDRM, and then activate the SDRM to facilitate the restructuring of the remaining claims. Once the SDRM is activated, however, its voting provisions would apply to all claims that are impaired. As a result, therefore, the sovereign would be precluded from using the voting provisions to restructure one class of indebtedness while maintaining arrears on other types of indebtedness that fall within the scope of the SDRM.

27. **In the final analysis, whether a claim should be excluded from the SDRM's collective decision-making framework or included under the SDRM—perhaps as a separate class—will depend on the nature of the claim in question.** As noted above, claims of private creditors governed by foreign law (or subject to the jurisdiction of foreign courts) will need to be covered under the SDRM and, therefore, the only question will be whether such claims need to be divided into different classes (e.g., secured vs. unsecured) for intercreditor equity reasons. However, for other claims, most notably domestic debt and official bilateral debt, either of these approaches can be considered since collective action issues do not normally hamper the restructuring of these claims. The remainder of this section discusses the relative advantages of each approach for these claims.

B. Domestic Debt

28. **One of the most complex set of issues confronting sovereigns that need to embark on a restructuring concerns the treatment of domestic debt.** On the one hand, restructuring domestic debt may have important ramifications for economic performance, during both the crisis and the recovery periods. On the other hand, the characteristics of domestic debt instruments and the relevant investors may differ from those relating to international debt. The issue of the treatment of domestic debt is further complicated by the various considerations relevant to determining when debt is "domestic." Specifically, domestic debt could be distinguished from foreign debt on the basis of: (i) residency of the investor; (ii) currency of denomination (or indexation); or (iii) governing law—domestic *vs*. foreign.

29. **It is helpful to distinguish two sets of issues for purposes of analyzing the treatment of domestic debt in the context of a comprehensive restructuring.** The first involves an analysis of the economic rationale for the restructuring of domestic debt and the possible need to treat certain types of domestic debt differently in the restructuring process. Here it is helpful to distinguish between broad policy objectives of a restructuring that may have a bearing on the treatment of domestic debt, and the specific characteristics of individual instruments and of investors that, under some limited circumstances, could also have a bearing on the restructuring. The second involves the identification of those design features of the SDRM that will ensure that the treatment of domestic debt will be consistent with these considerations. For purposes of assessing the economic merits of restructuring domestic debt, the most relevant criteria are currency and residency. However, on the question of how the SDRM should be designed so as to restructure these claims in a manner that resolves collective action problems, the most relevant criterion is the governing law of the claim. This is because, as noted earlier, the governing law of the instrument determines the extent to which collective action problems will hamper the restructuring process.

Economic considerations

Policy considerations

30. **As discussed above, it is likely that domestic debt will need to be included in a comprehensive restructuring, both in order to achieve a sufficient reduction in the debt and debt-service burden to restore sustainability, and to address concerns relating to intercreditor equity. Nevertheless, the restructuring of certain types of domestic debt may have major implications for economic performance, as a result of its impact on the financial system and the operation of domestic capital markets.** Accordingly, some differentiation in the treatment of domestic debt may be warranted from the perspective of facilitating economic recovery and preserving asset values. At the same time, creditors will take account of the likely impact of the design of a restructuring proposal on a sovereign's capacity to generate resources for debt service in their assessment of intercreditor equity. While the design of restructuring plans would need to be considered on a case-by-case basis taking account, inter alia, of the composition of debt and the structure of the domestic financial system, the following examples illustrate possible areas for according certain types of debt some measure of priority:[15]

- Excluding a narrow range of domestic instruments from restructuring could help pave the way for the sovereign's relatively rapid return to domestic capital markets during what is likely to be a sustained interruption in access to international capital markets. In addition to providing a vehicle for nonmonetary financing for the budget, this could also provide an indirect instrument for monetary control.

- Protecting at least a core of the banking system by ensuring the availability of the assets required for banks to manage capital, liquidity, and exposure to market risks would help to protect the payments and settlement system, and the financial system's capacity to act as an intermediary for both domestic and foreign savings (including, importantly, short-term trade credit).

- Governments may consider that there is a need to shelter some domestic investors from the full impact of a restructuring in order to garner political support for an ambitious adjustment program. Clearly, this would need to be balanced against the need to achieve sufficient intercreditor equity in order to attract broad support for restructuring proposals.

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[15] In a similar vein, it would likely be appropriate to exclude short-term trade credits from a restructuring in order to help preserve the supply of essential imports and thereby limit the extent of economic dislocation.

Specific characteristics of individual instruments and investors

31. **In some cases, differentiation in the treatment of certain types of domestic debt may be warranted by the characteristics of the instruments in question and the investors**.

Currency of denomination (or indexation)

32. **The ability of sovereigns to continue to service debt instruments that are payable in local currency even in periods of acute stress, and the impact of the exchange rate on the real value of such instruments,[16] may in principle provide some limited scope for excluding such instruments from a restructuring**. This might be of particular relevance to short-term instruments, such as treasury bills, used by domestic banks to manage liquidity. In practice, however, the authorities' capacity to continue to service such instruments in periods of fiscal stress may be constrained by the monetary program and the need to avoid a sharp acceleration of inflation. This limitation will likely be reinforced by the impact of financial crises on confidence and the demand for money.

Residency

33. **Differences in the behavior of resident and nonresident investors may also provide a possible rationale for differentiating between the treatment of claims on the basis of residency**. In principle, capital held by residents may be less internationally mobile than capital held by nonresidents, on account of exchange controls, portfolio investment requirements for certain financial institutions, and long-term business and other interests of residents. At the same time, it would be desirable to preserve access to financing from residents in the aftermath of the crisis when it is unlikely that financing from nonresidents would be forthcoming for an extended period, as well as to help stabilize the domestic financial system. In practice, however, recent crises have witnessed capital flight by residents, and this tendency seems likely to be amplified over time by the secular trend toward globalization and increased mobility of capital. Indeed, to an increasing extent, resident and nonresident investors often hold similar instruments and trade actively with each other. Moreover, it may be difficult to make a distinction between residents and nonresidents operational, particularly in cases in which there are substantial holdings by investors who own the beneficial (economic) interest, but are not the lenders of record. By way of example, residents could own the beneficial interest through offshore investment funds (such as mutual funds). Alternatively, nonresident investors could hold the beneficial interest in claims managed by a domestic financial institution. In both examples investment decisions would likely reflect the normal behavior of investors holding the beneficial interest, rather than the

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[16] This would apply to fixed and floating rate instruments denominated in local currency, other than those for which debt service, though paid in local currency, is indexed to a foreign currency.

lender of record. Finally, as discussed above, while nonresident investors are likely to recognize the need to take steps to help stabilize the banking system, achieving a broad measure of equity between the treatment of resident and nonresident claims may be important from the perspective of mobilizing broad support for a restructuring.

Design features of the SDRM

34. **Beyond the need to decide on the extent to which domestic debt would be covered by a restructuring, and the extent to which the treatment of such debts would be differentiated, a separate question arises as to whether all of debt covered by a restructuring needs to be addressed under the SDRM in order for it to be restructured in an effective manner.**

35. **When addressing this issue, it is important to recognize that, given the objective of the SDRM, the critical question is whether the restructuring of the debt in question would be seriously undermined by collective action problems.** Viewed from this perspective, the most relevant criterion for distinguishing between domestic and external debt is the governing law and jurisdiction of the claim—rather than that of residency or currency. Accordingly, the following discussion relies on this distinction when assessing the alternative approaches that could be taken.

36. **At a minimum, and as discussed at the outset of this section, claims that are governed by foreign law (or subject to the jurisdiction of foreign courts) will need to be covered under the SDRM so as to address collective action problems.** The qualified majority voting provisions of the SDRM will provide an important means of counteracting the legal leverage that individual holders of these claims would otherwise be able to exercise. This category of debt can include claims that may be considered "domestic," if "domestic," debt is defined either by the residency of the debt holder (the BOP definition) or currency of denomination. Specifically, claims that are governed by foreign law (or subject to the jurisdiction of a foreign court) are often held by residents. Moreover, while claims governed by foreign law are normally payable in foreign currency, they are—on relatively rare occasions—also payable in local currency.

37. **In contrast, the collective action problems that can arise in the restructuring of claims governed by domestic law (and subject to the jurisdiction of the domestic courts) are significantly less severe and, therefore, may justify different treatment under the SDRM.** In many respects, the sovereign already has the legal tools to minimize the collective action problems that may arise in the restructuring of these claims. When a creditor holds an instrument that is governed by domestic law and subject to the jurisdiction of the local courts, its ability to disrupt the restructuring process will be limited. In these circumstances, the sovereign may be able to amend its law in a manner that prevents the creditor from obtaining

a judgment on its original claim.[17] The tools available to the sovereign are not unlimited, however. In some countries, the constitution may preclude the sovereign from amending the domestic law for this purpose, and a creditor may be able to obtain a judgment in a local court. Although, in these cases, the domestic immunity laws will normally prevent a creditor from enforcing its claim locally, it may be able to have its judgment recognized and enforced abroad. The type of claims that are governed by domestic law and subject to the jurisdiction of the local courts can include debt to be considered "external", if "external," debt is defined according to the criteria of residency or currency. In some countries, nonresidents are significant holders of domestic law debt. Many emerging countries also issue debt governed by domestic law that is denominated in foreign currency. For this reason, "domestic debt", as used below, is defined to refer to debt that is governed by domestic law and subject to the exclusive jurisdiction of the domestic courts. External debt refers to all other private claims.

38. **In light of the above, one approach would be to exclude domestic debt from the SDRM and rely on the sovereign's existing legal powers to overcome the difficulties in restructuring domestic claims.** In those cases where a restructuring of both domestic and external debt was judged necessary, creditors holding external claims would be able to take account of the terms of the proposed domestic restructuring in their decision whether or not to accept a restructuring proposal. By the same token, creditors holding domestic claims would be able to review the terms of the external restructuring prior to deciding on their support for the restructuring of their own debt, but would not be able to hold up an agreement between a debtor and its external creditors. Moreover, in the context of a Fund-supported adjustment program, incentives to assure equitable treatment of domestic and external claims would be enhanced through the application of Fund conditionality, including through its lending into arrears policy. As discussed in paragraph 42 below, informal market contacts suggest that this option may be preferred by private creditors.

39. **An alternative approach would be for domestic claims to be covered by the SDRM, but as a separate class.** An affirmative vote by a majority of each class would be necessary for the overall restructuring to be effective, thereby giving holders of domestic and external claims a reciprocal veto over the terms offered to the other. The creation of a separate class would be justified on two grounds. First, it would reflect the fact that holders of instruments governed by domestic law have, in effect, claims with weaker enforcement rights against the sovereign than holders of claims governed by external law.[18] Second, in many cases, claims governed by domestic law are principally—although not exclusively—

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[17] In these circumstances, it will also be necessary for the local courts to have exclusive jurisdiction over the claim. If a foreign court obtains jurisdiction, the sovereign faces the risk that the foreign court may refuse to respect the modification of the domestic law on the grounds that it is contrary to the public policy of the forum.

[18] Of course, to the extent that holders of domestic claims are residents, they may have considerable political leverage over the government.

held by residents. Consequently, the creation of separate creditor classes could serve to mitigate the problems that could arise if all private debt were aggregated for voting purposes. Specifically, there may be concerns that the sovereign could be able to use its influence over resident institutions to have them vote to the disadvantage of foreign creditors. For example, residents could be persuaded to vote for significant reduction in the debt of all creditors in exchange for assurances that they would subsequently receive some form of compensation or regulatory forbearance.

40. **Each of the above approaches has its own advantages and disadvantages**.

- Bringing domestic debt within the SDRM would eliminate any residual legal leverage that holders of domestic law claims may be able to exercise as a means of undermining the restructuring process. (As noted above, the sovereign's powers in this area may not be unlimited.)

- Including domestic debt as a separate class would create greater incentives for coordination by giving each group a veto over the terms of the restructuring. However, giving holders the domestic law debt veto power over the entire restructuring may delay—or even block—the entire restructuring process. There may be circumstances where the sovereign and creditors holding external claims may be willing to agree upon the terms of a restructuring that is not acceptable to a qualified majority of creditors holding domestic claims.

- Inclusion of domestic debt as a separate class may also complicate the operation of the mechanism. As discussed above, domestic debt may be payable in foreign currency or indexed to a foreign currency. Holders of these claims are likely to have different interests from holders of debts denominated in domestic currency, particularly where the value of domestic currency claims is being eroded through inflation. Recognizing these differences may require the creation of additional creditor classes, even within domestic debt.[19]

41. **Differential treatment of domestic debt would need to be accommodated under either approach.** As discussed earlier, the special treatment of this debt may be particularly important in circumstances where much of the domestic debt is held by the banking system. In these cases, the framework would need to be sufficiently flexible to accommodate a number of different possibilities, including the offering of special terms, a sequenced restructuring (e.g., where domestic debt is restructured before foreign debt), or even the exemption of domestic debt from the restructuring process. Such flexibility would not necessarily be compromised if domestic debt were covered by the SDRM as a separate class.

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[19] In contrast, external debt is not often payable in domestic currency. In cases where it is, however, it is likely that an SDRM that only includes external debt would also need to provide for separate classes.

The establishment of a special class for such debt would provide a basis for an offer of special restructuring terms, and for restructuring on different terms if both classes agreed. Moreover, the sovereign could choose to exempt such debt from the restructuring process or restructure these claims outside the SDRM prior to restructuring external claims.[20] In either of these two cases when creditors holding external debt are offered to vote on their own restructuring terms, they would have to decide whether, for intercreditor equity reasons, they would insist on the domestic debt being restructured under the SDRM, even if it means reopening the earlier restructuring of that debt.[21]

42. **Consultations with foreign investors to date suggest that they would actually prefer to have domestic debt excluded from the SDRM.** As a general matter, they do not believe it is necessary for holders of domestic debt to be subject to the same legal framework that would be applied to external creditors—whether this framework is established by contract or by statute. For example, and as is discussed in the recently issued paper entitled The Design and Effectiveness of Collective Action Clauses, SM/02/173 (6/7/02), they are of the view that it is not necessary to include collective action clauses in debt governed by domestic law since the sovereign already has the legal instruments to address the holdout problem. Moreover, among the issues they have raised regarding SDRM, they have specifically expressed concern over a framework that would enable a qualified majority of domestic creditors to hold up a restructuring of external debt that had otherwise been agreed between the sovereign and the requisite majority of external creditors.

43. **If the SDRM will apply exclusively to external debt, it is very possible that some of these claims would be held by residents.** Accordingly, safeguards would still need to be in place to address the concern that the ability of the sovereign to influence residents could provide an opportunity for the sovereign to manipulate the voting process to its own

[20] There may be cases where a sovereign finds it necessary to proceed with a sequenced restructuring after it has initiated the SDRM. For example, as a means of preserving the banking system, it may need to restructure its domestic debt before it is in a position to reach an agreement on its external debt. Since the SDRM would have been activated, the voting provisions could provide a basis for holders of external debt to object to the terms of the restructuring offered to holders of domestic debt. For example, the terms of the stay on legal enforcement could provide that, absent agreement by a qualified majority of all creditors, the stay would automatically terminate if the sovereign restructures one class of indebtedness before an overall restructuring has been achieved. Moreover, the Fund's conditionality could also be used to ensure that any sequencing was adequately justified and paid due regard to intercreditor equity concerns. If the sovereign chose to restructure domestic debt after the activation of the SDRM, it could only use the voting provisions to achieve this if it also restructured the external debt at the same time, see paragraph 26.

[21] As noted in the initial portion of this section, a creditor class may only vote—and therefore may only exercise a veto—if its claims are being restructured under the SDRM.

advantage. Short of denying all residents a vote—which might be unjust—the most practical approach could be to rely on some form of limited ex ante statutory exclusion of creditors "under the control" of the sovereign (e.g., state-owned banks or enterprises) from the voting process. In addition, in circumstances where evidence suggests that undue influence has been placed by the sovereign on a creditor—whether a resident or otherwise—to vote in a particular manner (e.g., by providing financial incentives), those votes would be excluded. For such an approach to be effective in practice, it will require the establishment of a centralized dispute resolution process. The possible features of this process are discussed in Section IV.

C. Treatment of Official Bilateral Debt

44. **The claims of most official bilateral creditors are rescheduled under the auspices of the Paris Club (the "Club").** The Club's practices have been adapted over more than four decades to changing circumstances, and enable its members to respond rapidly to a debtor's external financing needs within the framework of Fund-supported adjustment programs. The rapidity with which Club creditors reach agreement on a restructuring provides a strong signal of bilateral creditors' support for the adjustment program. Moreover, the elimination of arrears helps to pave the way toward a resumption of export-credit cover. The Club's practices have been designed to assure that all Club creditors participate in a coordinated restructuring, which is facilitated by the Club's homogenous membership and the practice of these creditors of not resorting to litigation to enforce their claims.

45. **In many emerging economies, official bilateral claims constitute a relative small share of the sovereign's external debt.** Moreover, institutions for coordinating the restructuring of official bilateral claims are well developed.[22] Consequently, in most cases, the collective action problems among private creditors will be the most important impediment to a comprehensive restructuring of the sovereign's external debt. However, there are also cases where the claims of official bilateral creditors represent a significant share of the sovereign's external debt, [23] and coordinating the restructuring of claims held by private creditors and official bilateral creditors is a challenge.[24] Such coordination is

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[22] It is also worth noting that, in a few instances, non-Paris Club official bilateral creditors have on occasion extended bilateral support by purchasing an international sovereign bond issue.

[23] In Brazil, Mexico, Argentina and many Asian economies, official bilateral claims represent 10 percent or less of the sovereign's external debt. However, in Russia, Nigeria, Egypt, and Pakistan, official bilateral creditors hold over 50 percent of the sovereign's external debt that is not owed to the IFIs.

[24] "Restructuring" is used here as shorthand to describe a broad range of possible agreements, including flow reschedulings. It is not intended to imply stock treatment only.

particularly important in cases where a comprehensive restructuring of both groups of claims is needed to restore sustainability. This section explores whether the SDRM could be designed to provide a framework to improve coordination between official bilateral creditors and private external creditors, while at the same time taking into account the different nature of the respective claims.

46. **The shift over the last 15 years from syndicated lending by banks to securitized instruments held by a diffuse group of creditors has complicated the task of coordinating the restructuring of private and official bilateral creditors.** On the one hand, there is a timing issue. While Club creditors meet and agree on restructurings shortly after the approval of a Fund arrangement, private creditors may delay a restructuring until policies have started to take hold, and uncertainty has abated.[25] Moreover, at the time of the Club meeting, private creditors may not have organized in a representative group (though it is worth noting that the incentives for early organization would be shaped by both the Fund's lending into arrears policy and the design of the SDRM).[26] On the other hand, while Club creditors generally continue to provide flow restructurings, private creditors generally provide stock-of-debt operations. Appendix I provides additional background about Paris Club restructuring practices.

47. **This practice has led to concerns on the part of private creditors relating to intercreditor equity.** Private creditor groups have argued that in some cases, the Club establishes the minimum terms of the private sector's restructuring through its comparability of treatment provision,[27] yet the private sector does not have the opportunity to provide input into the terms of the Paris Club restructuring. They have also noted that, in other cases, the debtor country has sought significant debt and debt-service reduction from its private creditors in circumstances in which the Paris Club is providing nonconcessional relief (i.e., only rescheduling its claims).

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[25] See: Fund Policy on Lending into Arrears to Private Creditors—Further Consideration of the Good Faith Criteria, SM/02/248 (7/31/02).

[26] In one recent case, however, private creditors met with the Paris Club secretariat to discuss issues concerning the application of the comparability of treatment provision prior to the agreement on a Paris Club restructuring.

[27] A standard provision of the Club's Agreed Minutes commits debtors to seek comparable treatment from other creditors. The Club recognizes that other creditors may provide restructurings that are not identical to these provided by the Club, and retains discretion in the assessment of comparability. See: Involving the Private Sector in the Resolution of Financial Crises—The Treatment of the Claims of Private Sector and Paris Club Creditors—Preliminary Considerations, EBS/01/100 (6/28/01).

48. **The assessment of intercreditor equity between private creditors and the Club is complex, and involves several important considerations.** For example, some debtors have run arrears to Paris Club creditors for extended periods while staying current on their debt to private creditors. By the same token, the extension of maturities by private creditors in the context of restructurings may be shorter than those provided by the Club. In addition, Paris Club creditors reschedule over extended periods at interest rates linked to their costs of funds; this typically implies a substantial reduction in the present value of the claims when discounted at the secondary market yield on the debtor's other liabilities.

The SDRM and official bilateral claims

49. **Against this background, this subsection outlines two possible approaches for the design of the SDRM.** The first would retain the status quo, and would restructure the claims of official bilateral creditors outside the framework of the SDRM. The second would bring the claims of official bilateral creditors under the SDRM, though as a separate creditor class. Exploring options that would bring Paris Club creditors into an SDRM inevitably raises questions about how Paris Club processes might need to adapt for such debt restructuring to work smoothly. The intent of this section is to explore these issues in order to facilitate an informed debate, not to endorse the need to change existing Paris Club practices.

Exclusion from the SDRM

50. **One approach to consider would be to continue to restructure official bilateral claims outside the SDRM. Coordination between official bilateral and private creditors would be pursued outside the SDRM framework.** Both official bilateral creditors and private creditors would continue to take into account the terms of the restructuring, or if the other group has accepted or was likely to accept in deciding whether to restructure their own claims.

51. **Excluding the claims of official bilateral claims from the SDRM avoids any modification of the current decision-making process that applies to these claims.** Official bilateral creditors would continue to reach agreement on the terms of their restructuring through the Paris Club framework. They would presumably continue their current policy of requiring that the debtor seek comparable treatment from private creditors when private claims on the sovereign are judged to be material, and would also continue to assess whether the agreement of private creditors meet this requirement.

52. **As claims of Club creditors would not be subject to the SDRM, they would not participate in the SDRM's voting process alongside private creditors and approval of the Club would not be a necessary condition for private creditors to restructure under the SDRM.** Under this approach, the SDRM could potentially be used by a debtor to restructure the claims of private creditors at a time when the Club was not willing to restructure, e.g., because of the absence of a Fund arrangement. The claims of at least some private creditors would be restructured within the framework of the SDRM. A qualified majority of private creditors with claims subject to the SDRM would rely on its voting rules

to make decisions binding on all private creditors. These decisions would include the granting of a stay on litigation and the agreement on restructuring terms. In accepting the terms of a proposed restructuring of their claims, private creditors would be making an implicit judgment that the terms proposed by the debtor provide an acceptable degree of equity with the Paris Club's restructuring.[28]

53. **To the extent that the aggregated voting provisions of the SDRM assist in catalyzing collective action among private creditors, it may help private creditors come to single collective view on whether the terms of the Club's restructuring provide an acceptable degree of equity.** This may enhance coordination between private and official bilateral creditors. However, such coordination would not be assured by the design of the mechanism. For example, there would remain a risk that private creditors might demand the reopening of a Club restructuring before they would agree to restructure their claims, and that the Club might conclude that a private restructuring failed to meet its comparability requirement.

Inclusion in the SDRM

54. **An alternative approach to consider would bring official bilateral claims under the SDRM, but as a separate creditor class.** Under the SDRM, official bilateral creditors and private creditors would vote in separate classes. Support by the necessary threshold in each class would be required in order for the restructuring terms offered to both classes to become legally binding under the SDRM. There would be no aggregation across classes, so in no circumstances could a vote of private creditors impose restructuring terms on Club creditors, or vice versa. In effect, the framework would give official bilateral creditors and private creditors a mutual veto over the terms offered to the other. Since the restructuring would take place within the same time frame, it would establish a framework for consultation and coordination between private and bilateral official creditors, while taking into account their distinct interests. Most importantly, the terms of the restructurings offered to official bilateral creditors could be different from those offered to the private sector, so long as both creditor groups accepted them. Thus, for example, it would still be possible for the Club not to provide debt reduction, given its budgetary implications for many Club members, in cases where the private sector was prepared to agree to reduce its own debt. Similarly, it would be possible for private external creditors to obtain a larger share of the available cash flow in the near term than Paris Club creditors, increasing the market value of their agreement, so long as the Paris Club consented to such treatment. Under this approach it would not be possible to use the voting provisions of the SDRM to restructure the claims of private creditors without in the same time frame addressing arrears (if any) to Paris Club creditors (see paragraph 26).

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[28] For a discussion of the differences between Paris Club practices and current market practices, see EBS/01/100 (6/28/01).

55. **Although the creation of classes would preclude one class from imposing the terms of its restructuring on the other, each class could use the veto process to exercise leverage.** However, in deciding whether to exercise this leverage, creditors would need to consider the costs associated with delay. For example, in cases where private creditors were of the view that Paris Club creditors should provide debt reduction, they would have to be willing to delay the restructuring of their own claims (and the resumption of debt service) in the hope that Paris Club creditors would eventually agree on the need to provide debt reduction and obtain the necessary budgetary authority. By the same token, the Paris Club might be unwilling to approve an overall restructuring if it judged that the private restructuring failed to meet its comparability of treatment requirement.

56. **Such an approach would represent a significant departure from the existing process for coordinating the restructuring of official bilateral and private claims.** In order for this process to work effectively, a number of the Paris Club's existing practices might need to be modified, as will be discussed in greater detail below. The coordination needed for both creditor groups to agree on the final restructuring would, at a minimum, demand substantially greater consultation and dialogue between the two groups than has been the practice to date. At the same time, there might be a need for both creditor groups to show greater flexibility and to accept the need for restructuring the claims of different groups on different terms. Absent such flexibility and greater coordination, a process based on simultaneous approval with a mutual veto may risk to slow down some restructurings.

57. **The appropriate sequencing of restructuring private and official claims would need to be addressed.** This would be of central importance if official bilateral creditors are brought into the SDRM, though it also arises if these claims are excluded. From the perspective of achieving adequate intercreditor equity, it would be desirable for restructurings to take place in the same time frame. The basic premise of the mechanism is that the restructuring should not be completed until both creditor groups are comfortable with the terms proposed to both groups. However, this may conflict with other objectives, and so it may be desirable to introduce sufficient flexibility to allow for some sequenced restructurings. For example, in some cases, the member may reach rapid agreement on a Fund-supported program, and official creditors may be willing to agree to restructure their claims before the member will be able to reach agreement with its private creditors. Private creditors may need time to organize and to allow uncertainty to abate, and so may not be willing to restructure shortly after Board approval of a Fund arrangement. Nevertheless, signaling agreement of official bilateral creditors on a restructuring could provide an important signal of international support for a member's adjustment efforts, even if the Club's restructuring cannot be executed until private creditors reach agreement and signal their support for the overall agreement.[29] Moreover, in circumstances where the exposure of

[29] It is also possible that private creditors may approve their restructuring in advance of the Paris Club even if it cannot be executed until the Paris Club also signals its support for the restructuring, or even proceed with their own restructuring outside of the context of the SDRM.

either the official bilateral creditors or private creditors is minimal, it may not be necessary to provide for a simultaneous restructuring of the claims of these two groups of creditors.

58. **In light of these sequencing issues, any framework that contemplates official bilateral claims being restructured under the SDRM would need to allow for flexibility to address the following circumstances.**

59. ***First, in cases where the claims of either private sector or official bilateral creditors are small, and where, therefore, intercreditor equity issues are unlikely to be of major importance, there should be sufficient flexibility to allow for a sequenced approach.*** The key question would be determining whether such a sequenced approach would be justified in a particular case. This would have to be based on the agreement of both two groups. Where, for example, the Club wished to restructure rapidly outside an SDRM, it would presumably consult with private creditors, and vice versa so as to obtain assurances that private creditors would not request that the restructuring be reopened at a later date.

60. ***Second, in cases where the claims of both private and official bilateral creditors are considered to be significant, but agreement on the final restructuring could take time, a process would need to be put in place that ensures that any delay in agreement does not prevent Club creditors from resuming normal export credit cover.*** One possible approach would be for Paris Club creditors to modify their policies so as to allow the resumption of export credit cover in the absence of a restructuring, so long as the country had reached agreement on a Fund–supported program and private creditors, operating the framework of the SDRM, had agreed to a stay on the enforcement of their claims. An alternative possible approach would be for the Club to adopt a two-stage procedure. In the first stage, the Club could enter into an agreement on either a temporary standstill or a flow restructuring covering a relatively brief period. Such a temporary regularization of payments to Club creditors would be intended to both signal creditors' support for the adjustment program, and to allow for the resumption of export credit cover. At the same time, the Club could indicate its intention to provide a comprehensive debt reorganization within a period of say, 6 months. So long as this interim restructuring did not provide for cash payment to Paris Club creditors, the two-step procedure would not prejudice the interests of private creditors, and would not need their approval. The first stage would be a precursor to discussions with both creditor classes with a view to elaborating proposals for a restructuring to restore sustainability that could attract broad support within the framework of the SDRM (i.e., through votes of the two creditor classes in a manner that would provide them with a mutual veto). Achieving adequate intercreditor equity in order to garner broad support would clearly be critical in this regard.

61. **A final set of questions that would need to be resolved relates to representation and voting.** As noted above, the framework implies that there could be considerable dialogue between official bilateral creditors and private creditors and that each class would vote on the restructuring package. Issues that would need to be addressed include:

- Would the SDRM require the Paris Club departing from its practice of reaching understandings by consensus and accepting a framework that enabled a qualified majority to bind all Club creditors? Not necessarily. The SDRM could be designed to exclude the Club from the SDRM's majority voting and leave the Club's decision-making process the sole purview of the Club.

- On a related issue, how would the claims of non-Club official bilateral creditors be represented in the creditor class and the decision-making process? In some cases, Club creditors might have a qualified majority of principal, and therefore a consensus decision among Club creditors would bind other bilateral creditors. In other cases, however, non-Club creditors could hold a larger proportion of claims, and would need to provide some support to achieve a qualified majority.

- A separate issue relates to the respective roles of the Agreed Minute of the Paris Club (which is a statement of an intention by the representatives of official creditors to recommend restructuring on the specified terms) and the bilateral agreements (where the proposed restructuring is given legal effect). If decisions by these representatives were to be legally binding, this would require changes in domestic legislation.

62. **It is important to recognize the possibility that either private creditors or the Paris Club could reach agreement in the "shadow of the SDRM." Such agreements would not make use of the mechanism's legal powers or require that the SDRM's voting procedures be used.** Agreements in the shadow of the SDRM could be done without coordinating with other groups or their approval. For example, private creditors might conclude that the advantages of a rapid resumption of debt service outweighed the disadvantages of restructuring prior to the Paris Club restructuring.

63. **Preliminary consultations with some foreign investors active in the market for emerging market debt to date suggest that, from their intercreditor equity perspective, they have interest in exploring options for including official bilateral claims in the SDRM, albeit as a separate class.** As discussed in the previous subsection, this is in contrast to their preliminary views on the treatment of domestic debt, which they would prefer to have excluded from the SDRM. Their attitude reflects, in part, recognition that official bilateral creditors—unlike domestic creditors—already have considerable leverage over private creditors under the existing framework. These initial consultations, however, were not informed by the details of the alternatives presented here.

IV. Sovereign Debt Dispute Resolution Forum

64. In previous Executive Board papers, it has been recognized that an essential feature of the proposed SDRM would be the establishment, through an amendment of the Fund's Articles of Agreement, of a dispute resolution forum with the very limited role of administering creditor claims and resolving disputes involving those claims. While the powers of the Sovereign Debt Dispute Resolution Forum (SDDRF) would be limited, the effective exercise of these powers would play a critical role in ensuring that a collective framework that aggregates claims for voting purposes is both predictable and equitable. Such a forum would have exclusive jurisdiction over all disputes arising between the debtor and its creditors and disputes among creditors. It has been noted that the alternative—reliance on domestic legislation and domestic courts—would lead to a fragmented process, with different claims being subject to the jurisdiction of different national courts. The establishment of a single and exclusive dispute resolution forum would provide for legal uniformity in all jurisdictions and ensure uniform interpretation. Additionally, it has been emphasized that the proposed forum would have to be established in such a way that it operated—and would be perceived to operate—independently from the Executive Board, the Board of Governors, and the management and staff of the Fund.

65. Building upon the above general considerations, this section focuses on: (i) the powers of the proposed SDDRF, namely, the administration of claims and dispute resolution and (ii) its composition.

A. Powers

66. ***Administration of Claims***. It would be expected that the SDDRF would perform a number of purely administrative functions that would, among other things, facilitate the voting process. These would include:

- ***Notification to creditors,*** including, for example, notices regarding: (a) the request for activation by the debtor; (b) the identification of and listing of claims submitted by creditors; and (c) dates, place, and procedures for voting;

- ***Administration of the voting process,*** including the organization of meetings where voting would take place and the recordation of votes that have been cast; and

- ***Registration of claims.*** Consideration could be given to giving the SDDRF the responsibility for administering a permanent sovereign claims registry, which could be voluntary. While this would greatly facilitate the voting process when a crisis arises, it would also expand the responsibilities of the SDDRF. An alternative would be the creation of a private entity to perform a similar function.[30]

67. The above functions would be administered by a small secretariat, which would support the dispute settlement panels that would be established on an ad hoc basis. The treaty would also give the SDDRF limited authority to establish procedural rules to facilitate the administration of claims.

68. ***Dispute Resolution***. The SDDRF would be charged with resolving disputes arising between the debtor and creditors on the one hand, and amongst creditors on the other hand. This function would be a particularly critical element of a restructuring framework that provided for the aggregation of creditor claims for voting purposes. Two of the key areas where disputes can be expected to arise are as follows:

- ***Verification of claims.*** There will likely be disputes regarding both the validity and the value of the claims of creditors. For example, in the context of a framework that aggregates claims for voting purposes, creditors will be particularly concerned about the creation of fictitious claims that could be used to manipulate the voting process. Disputes may also arise regarding the value of claims and the collateral that secures the claims; and

- ***Integrity of the voting process.*** If claims are to be aggregated across instruments for voting purposes, ensuring integrity of the voting will be of critical importance. Assuming that all the submitted claims are bona fide, there will still be a risk of collusion between the debtors and certain creditors in the voting process. The most obvious concern will be "vote buying": there may be allegations that undisclosed financial incentives were provided by the debtor to induce a qualified majority in a certain manner. If, for example, entities under the control of the sovereign are to be excluded because of concern about improper influence by the sovereign, the SDDRF would have to resolve disputes as to whether, in a particular case, the creditor is in fact under the sovereign's control. While the provisions of the SDRM would contain rules that would safeguard against these abuses, the SDDRF would need to resolve disputes regarding their interpretation and application. In addition, the SDDRF would resolve disputes that may arise regarding the creation of additional creditor classes not specified in the treaty, if the treaty so allows.

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[30] Consideration could also be given to creating registry for any security interest that has been created in the context sovereign lending. Among other things, such a registry could provide notice to creditors that certain assets of the sovereign have already been encumbered.

- ***Creditor classification.*** As discussed in Section III, there may be merit in designing the SDRM in a manner that enables creditor classes to be established on a case-by-case basis, taking into account the general criteria established in the text of the treaty. If this approach were followed, it is likely that disputes would arise as to whether these criteria have been appropriately applied in a particular case.

69. The SDDRF would also require authority to make procedural rules for the resolution of disputes.

70. ***Legal effect and finality of SDDRF decisions.*** A distinction should be made between two categories of decisions that the SDDRF would be required to make.

71. The first category would involve a certification that an agreement between the debtor and a qualified majority of its creditors (such as the approval of a stay or the terms of a restructuring agreement) has been reached in accordance with required procedures. Such certifications would have a direct binding effect in all member countries of the Fund (whether or not the member in question was a party to the proceeding) and would not be subject to challenge in domestic courts. Accordingly, and by way of example, once a certification has been issued regarding the effectiveness of the restructuring agreement, a domestic court could not enforce a claim of a minority dissident creditor under the original agreement.

72. It should be emphasized that certifications would be based exclusively on the decisions made by the debtor and a qualified majority of creditors. The dispute resolution forum would, in effect, only be certifying that the agreement had been reached in accordance with the procedural requirements. The certification would not be based on the exercise of a dispute resolution panel's discretion.

73. The second category involves decisions made by the SDDRF in connection with the resolution of disputes between the debtor and its creditors or among creditors. Decisions in this category would not have a binding effect in member countries. However, as with certifications, these other decisions would not be subject to challenge in domestic courts nor in any regional or international court or forum. Accordingly, while an interpretation rendered by the SDDRF could not be challenged for purposes of any SDRM proceeding, the SDDRF's interpretation would not be binding for purposes of any other proceeding that may be initiated in a national court. Moreover, the Executive Board's power to interpret the Fund's Articles (pursuant to Article XXIX) would not apply to the SDDRF's interpretation of those provisions of the Articles that relate to the SDRM. When resolving disputes regarding the validity or terms of a creditor's claim, the SDDRF would apply the law of the jurisdiction that governs this claim.

74. In summary, the SDDRF's substantive powers would be limited to the administration of claims and dispute resolution as discussed above. Specifically, the SDDRF would have no authority to challenge decisions made by the Executive Board of the IMF, including with regard to the adequacy of a member's policies or the sustainability of the member's debt for

purposes of Fund financial assistance. Moreover, the SDDRF would not play an active role in the application of the SDRM provisions. Its role would be essentially reactive. Thus, although it could be given the power by the treaty to resolve disputes regarding the application of creditor classification rules, the SDDRF would not itself be responsible for classifying creditors. Of course, in order to exercise its very limited substantive powers, the SDDRF would require authority to establish procedural rules to facilitate the resolution of the process.

B. Composition

75. In order to command the prestige and widespread legitimacy necessary for it to effectively exercise its functions, the manner in which the SDDRF is established, its membership, and the way in which it exercises its functions must be guided by four basic principles, namely, independence, competence, diversity and impartiality. There are a number of possible ways in which these principles could be implemented. One possible approach would be through the establishment of the type of selection procedure discussed below.

76. As a first step, each of the 184 members of the Fund would have the right to nominate one candidate, who needs not to be a national of the nominating member.[31] Such a large pool of nominees would ensure diversity of geographical region and legal tradition, and the inclusion of members from both debtor and creditor countries. The nominations by member countries rather than by the Executive Board would also ensure independence from the Fund.

77. In the next step, an independent and qualified committee of eminent persons could be established by the Executive Board to vet the list of nominees, paying due regard to the four basic principles identified above. The Committee could be made up of, perhaps, 10-11 judges of the highest courts in 10-11 representative member countries of the Fund. The Committee would recommend, say, 21 names from the list of nominees for presentation to the Board of Governors for selection to the SDDRF. In assessing the candidates, the Committee could take into account the advice of independent, international, professional associations that are expert in insolvency and debt restructuring such as the International Federation of Insolvency Professionals (INSOL International), the International Bar Association's Committee J, and the International Insolvency Institute (III). In addition, to ensure adequate representation of the views of private creditors, the Committee could consult widely with representative associations of private creditors. A number of private creditors have indicated that they would prefer the members of the dispute resolution forum to be practicing judges experienced in debt restructuring. While acknowledging this preference, membership could also be open to retired judges, academics, or practitioners if that were felt appropriate.

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[31] The same candidate could be nominated by several members.

78. In the third step, the list of recommended names would be transmitted to the Board of Governors for approval. The Board of Governors would make its decision by an up or down vote of the entire list. If the Board of Governors did not approve the entire list, the process would have to be repeated. Following the decision of the Board of Governors, the Managing Director would make the appointment of each member of the SDDRF. Members could serve for fixed renewable terms. By way of example, members could serve for terms of, say, six years, with one-half of the members coming up for renewal every three years.

79. In the fourth step, the 21 appointed members of the SDDRF would organize themselves to elect a presiding member from among themselves. The presiding member would have specified duties related to overseeing the functions and operations of the SDDRF. It should be emphasized that the 21 members of the SDDRF, including the presiding member, would not be full-time employees of the SDDRF. They would continue to work in their other capacities unless they were impaneled for a particular case (see below), in which case they would be required in Washington, D.C.

80. In the final step, when an actual case is submitted to the SDDRF, three members of the SDDRF would be impaneled by the presiding member. The Presiding Member would take due care to ensure that members with conflicts of interest in specific cases are not permitted to serve on those cases. Procedures on how conflicts of interest are to be identified and resolved would need to be established.

81. As mentioned before, the SDDRF would need rule-making authority to enable it to make procedural rules. The authority to make such procedural rules would be specified in the text of the treaty establishing the SDRM. A drafting committee of, say, five members, including the presiding member, would be constituted by the presiding member for the purpose of drafting required rules. The rules would have to be ratified by the SDDRF as a whole, in accordance with a procedure that could be specified in the treaty.

V. Issues For Discussion

72. The paper revisits the rationale of the SDRM and describes its general features. Directors may wish to express their views on whether the SDRM would provide for a more rapid, orderly and predictable debt restructuring process than currently exists.

73. The paper discusses the need to design a legal framework that can be sufficiently comprehensive to facilitate the simultaneous restructuring of a broad range of debt that may be needed to restore sustainability while, at the same time, be flexible enough to accommodate the fact that: (i) creditors may have different types of claims and (ii) a sequenced approach to restructuring may, on occasion, be necessary. Directors may wish to comment on the merits of creating creditor classes as a means of providing the needed balance between breadth and flexibility, taking into account the general considerations identified in Section III.A.

74. The paper proposes distinguishing between external and domestic debt on the basis of governing law, and discusses two alternative approaches to the treatment debt that is governed by domestic law and subject to the exclusive jurisdiction of the local courts in the SDRM. The first approach would be to include such debt under the SDRM, but as a separate class. The second would exclude such debt from the SDRM and instead rely on a combination of the program and the need to develop a restructuring that would be acceptable to all creditors' groups to provide for intercreditor equity and a restructuring that is sufficiently comprehensive to achieve the change in the debt structure needed to ensure sustainability. Directors may wish to express their preference. Would yet another approach be preferable?

75. The paper discusses the existing framework for restructuring official bilateral claims (the Paris Club) and analyzes two alternative ways in which the SDRM would apply to these claims. Under the first approach, the SDRM would not apply to the restructuring of official bilateral claims but, by facilitating collective action among private creditors, it may nonetheless enhance coordination between the Paris Club and private creditors. Under the second approach, official bilateral claims would be subject to the SDRM, but would vote in a separate class and, accordingly, could also restructure on different terms than those received by private creditors, so long as both creditor groups agreed. Directors may wish to express their views on the relative advantages of each approach.

76. The paper provides further analysis of the possible powers and composition of a Sovereign Debt Dispute Resolution Forum. Do Directors agree that the powers of the SDDRF should be those described in the paper? Are they of the view that the type of selection and appointment procedure set forth in the paper provides a basis for ensuring that the SDDRF is—and is perceived as being—competent, independent, diverse and impartial?

BACKGROUND ON THE PARIS CLUB

77. The claims of official bilateral creditors on middle-income countries are predominantly officially supported export credits that were extended to, or guaranteed by, the debtor sovereign. These claims may also include aid loans and other bilateral loans. The repayment terms extended by the Club in a rescheduling are the result of a negotiation process. The Club typically applies to middle-income countries so-called Houston terms, which provide for rescheduled debts to be repaid over 15 years (including a grace period of up to eight years) for commercial loans, and maturities up to 20 years (including a grace period of up to 10 years) for aid loans. The precise terms in each case are tailored to the circumstances of the debtor concerned; in practice, maturities of up to 19 years have been agreed for commercial loans. Interest rates on restructured debt are typically established on a bilateral basis with each creditor at a small margin over the creditors' cost of funds.[32]

78. Prior to the approval of a Fund arrangement, Club creditors provide the Fund with an informal indication of their willingness to extend relief broadly in line with the program's financing assumptions. Following the approval of the arrangement, the Club will meet with the debtor to negotiate a restructuring, typically within 1-2 months of the approval of the Fund arrangement. The terms of the restructuring are recorded in the Agreed Minute, which provides a framework for the subsequent negotiation of bilateral agreements between the creditors and the debtor, that give full legal effect to the restructurings. The Fund has adopted the practice of treating an agreement by Club creditors as providing the basis for financing assurances and, through the comparability of treatment assumption, the elimination of arrears under the program to all official bilateral creditors, including those that are not members of the Club.

79. The speed with which Club creditors reach agreement on a rescheduling provides a strong signal of their support for the adjustment program. Moreover, the elimination of arrears may help to pave the way toward a resumption of export credit cover, and supports the Fund's policy of nontoleration of arrears to official creditors.

80. The coverage of Club reschedulings is decided in light of the debtor's financing needs. While reschedulings typically cover original maturities of principal and interest on pre-cutoff date debt, coverage may include maturities on previously rescheduled debt (but not maturities falling due under the most recent Club rescheduling). In particularly difficult cases, creditors have provided for the elimination of arrears on short-term obligations through some combination of reschedulings, deferrals over relatively short periods, and cash

[32] Repayment terms on restructured aid credits are typically somewhat more generous, while the interest rate applied to the restructured obligation would be no higher than that on the original aid loan.

payments. All Club Agreed Minutes include a comparability of treatment clause under which the debtor agrees to seek restructurings on at least as favorable terms from other creditors.[33]

81. In the 1980s, it was relatively common for debtors seeking a restructuring to have significant obligations to both official bilateral creditors and private creditors, predominantly commercial banks. Prior to the 1989 modification to the Fund's lending into arrears policy and the start of the Brady initiative, coordination between private and Club creditors was relatively straightforward. Debts to both groups were restructured in broadly the same time frame, which facilitated informal dialogue, while both creditor groups used broadly similar approaches to restructuring. Specifically, both provided flow restructurings of current maturities and outstanding arrears;[34] and neither provided stock-of-debt operations.

[33] Issues concerning the comparability of treatment were discussed in an earlier paper: Involving the Private Sector in the Resolution of Financial Crises—The Treatment of the Claims of Private Sector and Paris Club Creditors—Preliminary Considerations, EBS/01/100 (11/29/01), and. Also the summing up.

[34] It should be noted that for regulatory reasons banks were not willing to restructure current interest, but would instead provide new money packages that were intended to help debtors meet interest obligations.