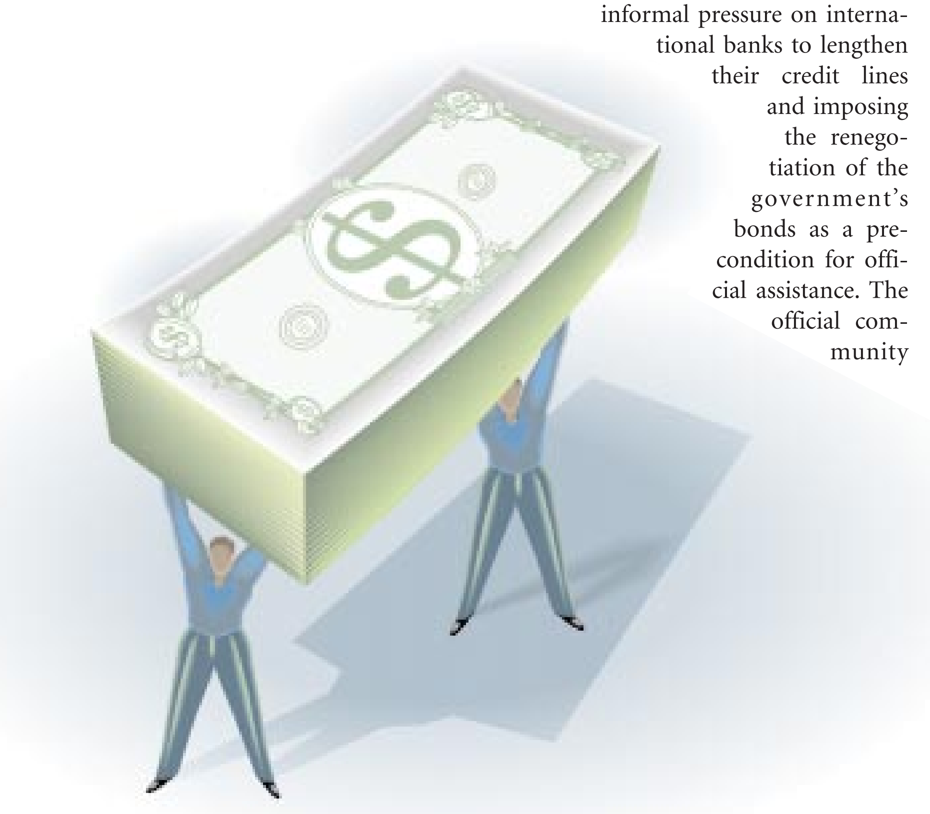
Is Greater Private Sector Burden Sharing Impossible?

Finding ways to "bail in" the private sector is an important element of crisis prevention and resolution. Yet no mechanisms are universally applicable, and some proposed strategies could precipitate the crises they were meant to forestall.

Barry Eichengreen

FINDING better ways of compelling investors to share the financial burden when crisis strikes is key to learning to deal with modern financial crises. Recent experience has heightened concerns that international rescue packages have let creditors off the hook and are a source of moral hazard. The IMF has experimented with a variety of methods, including putting direct and informal pressure on international banks to lengthen their credit lines and imposing the renegotiation of the government's bonds as a precondition for official assistance. The official community has encouraged the adoption of new provisions in loan contracts to facilitate orderly restructurings and to create workable alternatives to ever-bigger IMF bailouts. Governments have proposed, and international bodies have contemplated, more far-reaching options, including rules for IMF lending that would impose formulas for bail-ins and amendment of the IMF's Articles of Agreement to provide for an officially sanctioned standstill on payments.



Yet progress on this problem has been slight. The reason, some have suggested, is that bailing in the private sector is immensely complicated. Creditors are heterogeneous; it is not clear that bank creditors and bondholders can or should be treated in identical ways. The logistics of orderly restructurings are formidable in a world of custodial notes, credit derivatives, and cross-default clauses. Above all, it is important to avoid financial and policy innovations with unintended consequences, precipitating the very crises that officials wish to forestall. The gravity of these difficulties has led pessimists to conclude that greater private sector burden sharing may be impossible. Still, the urgency of the problem suggests that the search for the best approach—whether rules-based or discretionary—should continue.

Direct and indirect pressure on banks: Korea and Brazil

Unlike other countries where there were serious problems with economic fundamentals at home, Korea's problem in 1997 was primarily a liquidity crisis. The country had been recovering from a slowdown in 1996, when the prices of semiconductors (its single biggest export item) fell sharply. Slow growth and depreciated currencies elsewhere in Asia were already creating questions about whether the country's progress could be sustained. As business failures mounted, concern spread for the viability of the banks to which the *chaebol* (industrial conglomerates) were linked. Korean banks thus found it increasingly expensive to fund themselves abroad. Meanwhile, investors suffering losses elsewhere in Asia liquidated their investments in Korea in order to rebalance their portfolios and raise cash, intensifying pressures on the financial system.

The negotiation and approval of an IMF package on December 4, 1997, brought only temporary respite. Revelations that the country's short-term debt was significantly higher than previously thought, combined with the government's reluctance to close troubled banks, undermined confidence among international investors. Foreign creditors refused to renew their maturing short-term loans and withdrew their money even faster than the IMF and Group of Seven governments pumped it in.

In the week between Christmas and the New Year, the foreign commercial banks with credits to Korea held emergency negotiations with the new government of Kim Dae Jung, under the stewardship and with the moral suasion of Group of Seven central banks. European, Japanese, and U.S. banks agreed to roll over their loans through March, allowing the government to negotiate a more comprehensive restructuring package. On January 28, 1998, Korea and the banks reached an agreement on the rescheduling of $24 billion of debt and on a plan to replace the bank loans with sovereign-guaranteed bonds.

This version of bailing in the private sector did not require bank creditors to "take a hit"—they did not suffer significant losses. They merely agreed to extend the maturity of their claims, for which they were generously compensated. While this outcome did not avert a serious recession, it did facilitate the rapid restoration of creditworthiness. Korea was able to return to international capital markets as early as May 1998.

But there are good reasons for thinking that the Korean operation cannot be repeated. Above all, it is unlikely that future obligations will be to banks to the same extent. In Korea's case, the amount of external debt acquired through the bond and bill market was particularly small, allowing it to be carved out of the rescheduling agreement. The disproportionate importance of bank debt reflected the asymmetric opening of the Korean capital account, a policy that greatly heightened Korea's susceptibility to crisis. As other countries come to appreciate (it is hoped) the importance of opening the capital account more symmetrically, this mistake is unlikely to be repeated.

For this reason, a large number of heterogeneous creditors—and not just a few banks—will have to be bailed in during future operations, and peer pressure to stay in will be less effective. Moral suasion by central banks, regulators, and governments will operate less effectively on hedge funds, mutual funds, and individual investors than on a small number of international banks.

In addition, Korea had the advantage of a relatively strong economy; this made it possible to convince the banks that the country's plight was primarily a liquidity crisis rather than a deeper problem with fundamentals that justified serious doubts about whether it would be able to service even restructured debts in full. The country also had the advantage of a newly elected democratic government committed to pushing through economic reforms.

A similar initiative was taken in Brazil in early 1999. In this case, the effort to secure a commitment by the banks to maintain their lines was undertaken after the devaluation of the real but before the second (post-devaluation) IMF package. While this approach limited the use of IMF resources to pay off bank creditors, the banks have not taken losses comparable to those suffered by other investors in Brazilian markets. It is thus not clear that bank creditors have been taught the kind of lesson that will discourage excessive lending in the future.

In Brazil, the authorities went to great lengths to avoid giving the impression that bank creditors might be trapped into involuntary lending. They were concerned that such an impression could prompt the banks—worried that they would ultimately suffer losses—to cut their lines, thereby precipitating the very crisis that the authorities aimed to prevent. This episode points up one of the risks of formalizing procedures to bail in the banks. If national authorities and the IMF signal their intention to regularly contact the banks in times of crisis, demanding that they extend the maturity of their credits, banks valuing their liquidity and fearing default will have an incentive to get out in advance. Where the problem is transparently a liquidity crisis and it should be possible to convince the banks that it is in their collective interest to stay in, IMF intervention to help them coordinate on this more efficient equilibrium will be recognized as in everyone's inter-

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est. But where the problem may be one of solvency, the news that officials are about to try to rope in the banks will create an additional incentive for them to run. If the IMF decides to regularize Korean-style operations, then the news that a country has approached the IMF will immediately precipitate a crisis. In the real world, of course, lenders are unsure about which situation they face. Thus, the expectation that officials intend to bail them in will almost always incite them to scramble out. This suggests that the approach should be used sparingly if it is not to prove destabilizing.

Seniority and the case of Pakistan

An important issue is whether senior claimants should be granted immunity from restructuring agreements. Pakistan's case, which involves eurobonds, is informative. A combination of domestic economic and political problems in May 1998 drove Pakistan to approach the Paris Club to negotiate more than $700 million worth of eurobonds, along with its much larger debts to official creditors.

When a country comes to the Paris Club to renegotiate its official debt, the government is required to seek comparable treatment from its private creditors as well. The private creditors of Paris Club supplicants have typically been banks, not bondholders, since low-income countries with an overhang of official debts have found it understandably difficult to borrow on the bond market. Thus, the inclusion of bonds in the comparability provision of Pakistan's Paris Club Minute is precedent setting. Even though only a small fraction of the country's total external obligations could be subject to these new procedures, bondholders have nevertheless been worried that countries like Ecuador, Romania, and Russia could follow.

The market's objection is based on the fear that requiring comparable treatment of eurobonds—which have historically been treated as senior to other claims—will disrupt credit-market access by preventing emerging markets from establishing a clear seniority structure, since one of the impediments to market access is the absence of a legal framework establishing which debts have senior status relative to others. This lack of a clear understanding of the seniority of their claims discourages lending by risk-averse creditors.

The argument in favor of excluding bonds from comparability provisions is a variant of the general notion that efficient debt contracts balance the bonding role of debt when the contract is first agreed against the efficiency advantages of restructuring unviable obligations when the possibility of default looms. But these arguments create no presumption that senior claims should be immune from restructuring, any more than they create a presumption that senior claims in the domestic context should be exempted from all bankruptcy proceedings. There will be cases where comparability provisions have to be applied to eurobonds as well as to other claims. At the same time, assuming that eurobond holders will be bailed in threatens to disrupt the efforts of emerging economies to establish a clear seniority structure. The issue will obviously have to be considered on a case-by-case basis.

The case of American-style bonds

Countries are reluctant to suspend debt service as a way of bailing in foreign bondholders for fear that the subsequent restructuring will be costly and difficult. This is likely to be especially true of the "American-style" bonds that dominate sovereign debt markets. Typically, these instruments require the unanimous consent of bondholders to the terms of any restructuring, exposing the issuer to the risk of legal action by dissidents and threatening to trigger cross-default clauses in its other obligations, in turn activating acceleration clauses requiring those other obligations to be repaid. Unlike syndicated bank loans, American-style bonds lack sharing clauses requiring individual creditors to split with other bondholders any amounts recovered from the borrower and thereby discouraging recourse to lawsuits.

Those who believe that countries will need to have occasional recourse to suspensions and subsequent restructurings argue that these provisions should be changed. The objective is to make it easier to undertake negotiations—and therefore to provide an alternative to ever-bigger bailouts—by adding majority voting, sharing, and collective-representation clauses to bond covenants. The addition of such clauses is the only practical way of creating an environment conducive to flexible restructuring negotiations. And creating such an environment is essential if the IMF and the official community are to make a credible commitment not to run to the rescue of a crisis country with a basketful of funds.

If this is such a good idea, why have the markets not done it already? One answer is that, so long as the markets continue to believe that they will always get 100 cents on the dollar courtesy of the IMF, they are perfectly happy with the status quo.

Another answer is moral hazard. Neither lenders nor creditors may wish to weaken the bonding role of debt by altering loan agreements in ways that might tempt borrowers to walk away from their obligations. Making it easier for debtors to restructure might cause investors to fear that the debtor was

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prepared to do so at the first sign of trouble and prompt them to liquidate their holdings of the debtor's securities, precipitating precisely the kind of bond market crisis that the international policy community is concerned to avoid.

But if the bonding role of debt were the be-all and end-all, we would also abolish domestic bankruptcy procedures and reinstitute debtor's prison to prevent domestic borrowers from ever defaulting on their obligations. In fact, in the domestic context, we balance the temptation for debtors to walk away from their obligations against the efficiency advantages, for debtor and creditor alike, of clearing away unviable debt overhangs and restoring the financial health of fundamentally viable enterprises. The argument for collective-action clauses in bond covenants is an argument for creating an analogous balance in the international bond market. Majority voting, sharing, and nonacceleration clauses may make it easier to renegotiate defaulted debts, but if this means avoiding a long deadlock, investors will have no reason to shun bonds with these features.

One way of pushing ahead would be for the IMF to urge its members to make the inclusion of these clauses to international bonds a condition for admission to domestic markets. The IMF should provide an incentive for countries by indicating that it is prepared to lend at more attractive interest rates to countries that issue debt securities with these provisions. U.S. and U.K. regulators, for their part, could make the admission of international bonds to their markets a function of whether those bonds contain the relevant provisions. They could include these same provisions in their own debt instruments.

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Implications for the IMF

When a country has serious problems with fundamentals and there is concern that official assistance might be used to bail out private creditors, the IMF should consider encouraging the country to reschedule; to give the country leverage to do so, the IMF should condition its disbursements on the initiation of negotiations. Unfortunately, it is not clear that the preconditions for the quick conclusion of such negotiations—specifically, a cohesive group of creditors—will remain in place as the securitization of financial markets proceeds. This may force the IMF to lend into arrears.

In fact, lending into arrears is something that the IMF has long done when a government is making a concerted effort to adjust and has shown good faith in its negotiations with the creditor community. But this approach needs to be carried out cautiously, under carefully designed conditions and on a case-by-case basis. A regular policy of lending into arrears would make it too tempting for debtors to fall into arrears. And a policy of regularly requiring countries to renegotiate their commercial debts as a precondition for official assistance might precipitate additional crises, as banks or bondholders scrambled out of the country in anticipation of this eventuality. The IMF staff's June 1999 paper on lending into arrears takes many of these points on board. ("IMF Policy on Lending into Arrears to Private Creditors," prepared by the Policy Development and Review and Legal Departments of the IMF, is available on the IMF's website: **www.imf.org.**)

Given the difficulties with most proposals for bailing in the private sector, there is a role for the IMF in promoting the pursuit of policies that prevent the problem from arising in the first place. Better macroeconomic policies can minimize the incidence of currency crashes that impair the finances of banks and corporations with unhedged foreign exposures. Greater exchange rate flexibility can encourage banks and firms to hedge those exposures, preventing sharp movements in currencies from being transformed into financial crises. Debt-management policies that avoid excessive dependence on short-term debt and clumping of maturities can help to avert debt runs and minimize refunding risk. The adoption of transparent bankruptcy laws and independent judiciaries can prevent problems of illiquidity and insolvency from cascading through the economy as panicked investors scramble for collateral. It is trite but true—whether the topic is bailing in the private sector or any other aspect of financial crisis—that prevention is the better part of cure.

Conclusions

My review of the experience with attempts to bail in the private sector points to two conclusions. First, there will continue to be cases where even senior claims will have to be restructured, and others where they will not. While countries have an interest in establishing a clear seniority structure, the international community has an interest in containing the moral hazard that would result if senior claimants were automatically protected from haircuts. The uncomfortable fact is that the IMF cannot pretend to be uninvolved in this decision. So long as it is in the business of lending, it will have to decide whether to lend enough to let senior creditors off the hook.

Second, efforts to bail in the private sector will have to proceed on a case-by-case basis. Rules specifying the modalities and circumstances in which creditors will be bailed in run the risk of precipitating additional crises. The news that a country was approaching the IMF would then create the expectation that the IMF was preparing to bail them in, and the creditors would have an incentive to rush for the exits. Dealing with the problem on a case-by-case basis may seem arbitrary and unwieldy, but at least it does not pose the same danger of aggravating the problem. F&D