A SOVEREIGN DEBT RESTRUCTURING MECHANISM—FURTHER REFLECTIONS AND FUTURE WORK

February 14, 2002

I. INTRODUCTION

1. This note seeks to elaborate on a number of conceptual and operational issues associated with the Sovereign Debt Restructuring Mechanism (SDRM) that was outlined in the note circulated to the Executive Board on November 30, 2001 (the "Initial Note").[1] It also takes into consideration a number of the questions raised by Directors at the informal presentations of the SDRM. Specifically, the paper:

- Describes the objectives and key features of an SDRM and the set of circumstances it is designed to help address, i.e., cases where a sovereign debt restructuring is unavoidable (Section II).

- Discusses issues relating to, and alternative models for, the Fund's role in the operation of an SDRM (Section III).

- Provides further analysis regarding the legal basis for an SDRM and, in particular, the relative merits of establishing such a mechanism by statute rather than through contract (Section IV).

- Discusses the implications of an SDRM for nonsovereign debt in circumstances where the imposition of exchange controls has given rise to arrears on such debt (Section V).

- Identifies the range of issues that will require further work in designing and implementing an SDRM (Section VI).

Issues for discussion are set forth in Section VII.

2. With respect to the scope and structure of the paper, one issue merits particular emphasis. As was discussed in the Initial Note, there may be cases where the restructuring of sovereign debt may affect nonsovereign indebtedness; i.e. where residents are forced to default on their external indebtedness because of the implementation of exchange controls. The features of the SDRM that could be applicable to such debt, and the role of the Fund in this context, are discussed in Section V. Sections II through IV deal exclusively with the treatment of the sovereign debt under the mechanism.

[1] A New Approach to Sovereign Debt Restructuring—Preliminary Considerations, FO/DIS/01/151 (11/30/01).

II. The Objectives and Key Features of a Sovereign Debt Restructuring Mechanism

3. The objective of an SDRM would be to facilitate the orderly, predictable, and rapid restructuring of a sovereign's debt in those circumstances where the member's debt is judged to be unsustainable, while providing appropriate assurances regarding the protection of asset values and creditors' rights. If appropriately designed and implemented, such a mechanism could help to reduce the costs of a restructuring for sovereign debtors and their creditors, and contribute to the efficiency of international capital markets more generally.

4. It is envisaged that a sovereign debt restructuring mechanism could be invoked in only very limited circumstances. Specifically, its use would be restricted to those cases where a member's debt was judged unsustainable. In such a case there would be no feasible set of sustainable macroeconomic policies that would enable the member to resolve the immediate crisis and restore medium-term viability absent a significant reduction in the net present value of its debt. In many such cases, the member concerned will already have been implementing corrective policies, but will have reached the point where financial viability cannot be restored without a substantial adjustment in the debt burden. Clearly, members that are judged to have sustainable debt burdens may on occasion need to approach their creditors for a reprofiling of scheduled obligations. It is not intended that a SDRM should be used for such cases.

5. There are two key challenges to the successful design and implementation of an SDRM. The first is to create incentives for debtors with unsustainable debt burdens to address their problems promptly in a manner that preserves asset values and paves the way toward a restoration of sustainability, while avoiding the creation of incentives for the misuse of the mechanism. The second challenge is to design the mechanism so that, once activated, the relative roles assigned to the sovereign debtor and its creditors create incentives for all parties to reach rapid agreement on restructuring terms that are consistent with a return to sustainability.

6. The policies of the Fund regarding the availability of its resources before, during and after a member seeks a restructuring of its debt currently play a critical role in shaping these incentives. Whatever the form of the SDRM, the Fund's operations would continue to play a major role in determining these incentives. Whether the legal authority of the Fund would have to be enhanced under an SDRM, and—if so—to what extent, is discussed below in Section III.

7. If an SDRM were designed and implemented in a manner that achieved an appropriate balance of incentives, it would provide a number of benefits. Debtors would benefit from incentives that encouraged them to address unsustainable debt burdens at an early stage. They would also benefit from a greater capacity to resolve collective action problems that might otherwise thwart a rapid and orderly restructuring. Most creditors would also gain if the debtor acted before it had dissipated its reserves and would benefit from the resolution of collective action problems that would otherwise impede a

sustainable restructuring. Moreover, creditors would benefit from the creation of a predictable restructuring framework that provides assurances that the debtor will avoid actions that reduce the value of creditor claims. Finally, if an SDRM is sufficiently predictable, it will help creditors make better judgments regarding how any restructuring will take place and the recovery value of the debt. This should make sovereign debt more attractive as an asset class, increase the efficiency of international capital markets, and result in a better global allocation of capital.

Difficulties of creditors coordination

8. Sovereigns that have embarked on the process of integration into global capital markets have gone to extraordinary lengths to avoid a restructuring of their indebtedness. Although this reluctance is attributable to a number of factors, one central problem is the difficulty of securing collective action among creditors on a restructuring that reduces the sovereign's debt to a sustainable level. In particular, it may be difficult to secure high levels of participation by creditors in debt restructurings that would be in the interests of creditors as a group, as individual creditors may consider that their best interests would be served by trying to free-ride in the hope of ultimately receiving payments in line with their original contracts. Both free riding and other issues of intercreditor equity may inhibit creditors from accepting a proposed exchange, making it less likely that a deal will achieve the objective of restoring sustainability.

9. The increased scale of creditor coordination problems is primarily attributable to the evolution of capital markets towards traded securities, which has resulted in an increasingly diverse and diffuse creditor community. During the 1980s debt crisis, collective action problems were limited by the relative homogeneity of commercial bank creditors, the contractual provisions of syndicated loans,[2] and, on occasion, moral suasion applied by supervisory authorities.

10. The absence of a mechanism that provides for majority action among a diverse set of creditors represents a significant gap in the existing international financial architecture. An SDRM would seek to address this problem by creating a legal basis for majority action among creditors. If it can produce predictable outcomes, the SDRM will provide a framework that will enable debtors and creditors to develop informal approaches to resolving debt difficulties without the need for the formal activation of the mechanism.

Core features of the mechanism

11. The Initial Note identified four features of an SDRM that would enable it to achieve the above-stated objectives. The central feature is a mechanism that would enable a requisite majority of creditors to make a restructuring agreement binding on all

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[2] Specifically, sharing clauses that provided strong incentives for negotiated settlements rather than resort to litigation, and relatively high thresholds before creditors could accelerate a loan that was in default.

creditors (majority restructuring). This feature would be supported by three others: (i) a stay on legal action by creditors against the debtor following a suspension of payments; (ii) measures to protect the interests of creditors during the period of this stay; and (iii) a mechanism that induces the provision of new financing by private creditors during the period of the stay. The rationale for each of these features is discussed below.

12. ***Majority restructuring*** – The creation of a mechanism that would bind a dissenting minority to the terms of a restructuring would be the most important element of any new restructuring framework. From the perspective of creditors, such a mechanism would provide confidence that any forbearance exercised by the majority when agreeing to a restructuring would not be abused by free riders who could otherwise press for full payment after an agreement was reached. For the majority of creditors, the disruptive behavior of free riders not only raises intercreditor equity issues, but also reduces the ability of the debtor to service the newly restructured debt. From the perspective of the sovereign, the resolution of these collective action issues will make it more likely that it will be able to reach early agreement with creditors on a debt restructuring. Moreover, it eliminates the threat of disruptive litigation after the restructuring takes place.

13. Majority restructuring provisions form the central element of the collective action clauses that are found in some international sovereign bonds. However, these provisions only bind bondholders within the same issue. They have no effect on bondholders of other issuances and, moreover, do not apply to other types of indebtedness, such as bank claims and domestic debt. To address the collective action problems that arise from the very diverse creditor community that currently exists, such a mechanism would need to apply to all forms of private credit. This feature of an SDRM would be similar to the majority restructuring provisions of domestic insolvency laws, which aggregate the claims of all eligible creditors (irrespective of the nature of the instrument) when determining whether there is adequate support by a majority to make an agreement binding on all creditors. Ideally, the debtor and its creditors would reach agreement on a sustainable restructuring and activate the majority restructuring provision described above prior to a default on the original claims. As borne out by experience, avoiding a default would help to limit economic disruption and to preserve asset values, including the secondary market value of creditors' claims.

14. ***Stay on creditor enforcement*** – In the event that an agreement had not been reached prior to a default, a temporary stay on creditor litigation after a suspension of payments but before a restructuring agreement is reached would support the effective operation of the majority restructuring provision. In the context of corporate insolvency, a stay on litigation is intended to enforce collective action by preventing a rush to the courthouse and a "grab race" that could undermine the ability of a company to continue functioning, to the detriment of the debtor and its creditors (the value of whose claims is maximized when the company remains a going concern). The risk of widespread creditor litigation may be less pronounced in the sovereign than in the corporate context, largely on account of the relative scarcity of assets under the jurisdiction of foreign courts that could be seized to satisfy creditors' claims. Nevertheless, there is a risk that litigation could inhibit progress in the negotiations. This risk could increase if, as a result of the

introduction of a majority restructuring provision, the only opportunity to use legal enforcement as source of leverage is before rather than after the reaching of an agreement. This is one of the reasons why collective action clauses in international sovereign bonds also contain provisions that effectively enable a majority of bondholders to block legal action by a minority before an agreement is reached. But, as in the case of majority restructuring provisions, these provisions only apply to bondholders within the same issuance.

15. ***Protecting creditor interests*** – An SDRM would need to include safeguards that give creditors adequate assurances that their interests were being protected during the period of the stay. These safeguards would have two complementary elements. First, the sovereign debtor would be required not to make payments to nonpriority creditors. This would avoid the dissipation of resources that could be used to service the claims of private creditors in general. Second, there would have to be assurances that the debtor would conduct policies in a fashion that preserves asset values. If, throughout the stay, the member was implementing a Fund-supported program or was working closely with the Fund to elaborate policies that could be supported with the use of Fund resources, this would provide many of these assurances. Beyond the fiscal, monetary and exchange rate policies that lay the basis for the resumption of debt service and a return to sustainability, creditors also have clear interests in other policies, including, for example, the nature and terms of any domestic bank restructuring, the continued operation of the domestic payments system, the country's bankruptcy regime and the nature of any exchange controls it imposes. The creditors of the sovereign may have a particular interest in the effective implementation of capital controls to prevent capital flight.

16. ***Priority financing*** – A majority restructuring mechanism would also need to be buttressed by a mechanism that would facilitate the provision of new money from private creditors during the period of the stay. It is in the collective interests of private creditors and the sovereign debtor that new money be provided in appropriate amounts. Such financing, when used in the context of appropriate policies, can help limit the degree of economic dislocation and thereby help preserve the member's capacity to generate the resources for meeting debt-service obligations. In the sovereign context, new money could help cover the sovereign's need for trade credit and could also finance payments to priority creditors. Under the existing legal framework, however, individual creditors have no incentive to provide new money in such circumstances, as the benefits would be shared among creditors as a group, and there would be no assurance that the new financing would not also get caught up in the restructuring. An SDRM could induce new financing by providing an assurance that any financing in support of the member's program extended after the introduction of the stay would be exempt from the restructuring exercise.

17. As discussed further below, if this mechanism is to be both equitable and transparent for a broad range of creditors, it will have to be supported by independent arrangements for the verification of creditors' claims, the resolution of disputes, and the supervision of voting. For example, such arrangements would protect against fraud that may arise through the creation of debt between related parties.

18. All of the above features, when taken together, would establish a framework within which an orderly and rapid restructuring could take place. Most importantly, they would address collective action problems that have, to date, made the cost of restructuring excessively high for debtors and creditors alike. Such a framework could help creditors and debtors reach agreement on equitable restructuring terms more rapidly, and thus facilitate the country's recovery. Moreover, if the framework were sufficiently predictable, it would create the incentive for debtors and creditors to reach an agreement without having to rely on its actual use. For example, the voting provisions would encourage early creditor organization, and thus lay the basis for negotiations between the debtor and its creditors. In addition, potential holdouts would realize that, unless they are sufficiently flexible, the debtor and the majority of creditors could use the mechanism to bind them to the terms of an agreement.

III. The Role of the Fund in the Sovereign Debt Restructuring Mechanism

19. The financial support that the Fund provides for an effective economic adjustment program already shapes incentives that surround the sovereign debt restructuring process and would continue to do so under an SDRM. The critical question is whether, under an SDRM, the Fund's role would be limited to the exercise of its existing financial powers or whether it would exercise additional legal authority. The Initial Note outlined a framework that would give the Fund significant new legal authority (e.g. approval of the activation and maintenance of the stay). During the informal discussions, a number of Directors raised questions as to whether the grant of such authority was necessary. They noted that, as a creditor and as an institution that reflects the interests of the debtor and its official creditors, there might be a perception that the Fund would not be entirely impartial in exercising that authority. More generally, it was unclear whether there would be adequate support within the international community to confer additional powers on the Fund.

20. In response to these concerns, this section analyses the feasibility of an approach that would limit the role of the Fund in the operation of the mechanism itself. While decisions under the SDRM would be left to the debtor and the majority of its creditors, the Fund would necessarily continue to play a central role in defining incentives through the exercise of its existing powers.

A. Role of Fund Finance

21. In the existing environment, decisions by the Fund regarding the availability of its resources already influence all stages of the sovereign debt restructuring process. Specifically:

- Whether the Fund will provide financing already helps determine the timing of a sovereign payment suspension. Before a member decides to seek a comprehensive debt restructuring, it typically approaches the Fund for financing (either in the context of an existing or future arrangement) with aim of avoiding such a restructuring and the associated economic, social, and political disruption. On being approached, the Fund is required to make a judgment whether member's

debt burden is or is not sustainable. This judgment determines the availability and the appropriate scale of Fund financing. Consequently, decisions about the availability of Fund resources strongly influence a member's decision as to whether to suspend payments in order to conserve its remaining international reserves.

- After a member has suspended payments, it is currently expected to work with the Fund on the development of an appropriate economic policy framework, and to negotiate a debt restructuring with its creditors. Approval of a Fund-supported program often, but not always, precedes final agreement on restructuring terms with creditors. In this context, the Fund currently makes judgments about the good faith of the member in its negotiations with its creditors in determining whether to lend into arrears on payments to private creditors. The Fund-supported program will specify a fiscal and external adjustment path, which, when combined with decisions on official financing, will establish certain parameters for a viable restructuring. For example, the fiscal adjustment path, in conjunction with a monetary program backed by the Fund and other official financing, will determine, in broad terms, the amount of resources available for debt service by the sovereign during the program period.

- When deciding whether to support a member that is about to conclude a restructuring of its obligations to private creditors, the Fund currently makes two important judgments. First, it assesses the consistency of the restructuring agreement with the adjustment path in the member's economic program. The payments stream that emerges from the private debt restructuring should be consistent with the member's program. Second, it assesses whether the resulting medium-term payments profile is consistent with the requirements for debt sustainability.

22. Under an SDRM, the nature of the financing decisions that the Fund would need to make before, during and after a debt restructuring would not change. Consistent with its mandate, the Fund would continue to ensure that its resources were being used to resolve the member's balance of payments problems without resorting to measures that were destructive of national and international prosperity. Moreover, it would continue to need to ensure that there are adequate safeguards for the revolving character of its resources. Both of these imperatives would require it to continue to condition the availability of its resources on the adoption of appropriate policies and, where necessary, on a debt restructuring that laid the basis for a return to sustainability.

B. Operating the Mechanism

23. While the Fund would continue to exercise its existing authority when making financing decisions under the proposed sovereign debt restructuring mechanism, a separate question is whether it should be given additional legal authority in the operation of a SDRM.

24. The key decisions to be made under an SDRM relate to: (a) the activation of the stay, (b) the extension of the stay and (c) legal effectiveness of any debt restructuring agreement. This section explores the feasibility of leaving these decisions in the hands of the member and its creditors. Under such an approach, the Fund's decisions regarding the availability of its resources, as described in the previous section, would be designed to create the incentives for the various parties to use the mechanism appropriately. The feasibility of such an approach is analyzed below for each of the main features of the mechanism.

Approval of the restructuring agreement

25. In the Initial Note, it was suggested that a restructuring agreement would only become effective if it were approved both by the Fund's Executive Board and by the requisite majority of creditors. Fund approval of the restructuring would be based on a determination that the terms of the agreement provide for a sustainable debt profile.

26. Would it be feasible to eliminate the condition of formal Fund approval of the agreement? Relying exclusively on the approval of the requisite majority of the creditors as a means of making the agreement binding on all creditors would make this element of the mechanism consistent with the majority restructuring provisions found in collective action clauses. The key difference would be that, while majority restructuring provisions only apply to bondholders within the same issuance, an affirmative vote by the requisite creditors under the mechanism would bind the entire creditor body.

27. If this approach were followed, there could be a risk that the debtor and creditors would conclude an agreement that did not achieve a sustainable debt profile. However, this risk could be addressed, as it is in the present context, if subsequent Fund financial support is conditioned on a judgment that the payments stream in the proposed restructuring was consistent with the adjustment path in the member's economic program and the requirements for medium-term debt sustainability. If it did not meet these conditions, the Fund would be effectively prevented from lending until the member had taken further steps to ensure debt sustainability, possibly involving a further restructuring.

Activation of the stay

28. Under the framework outlined in the Initial Note, the stay could only be activated at the request of the member; but for the stay to be effective, such a request would also need to be endorsed by the Fund. Fund endorsement would be based on a determination that: (i) the member's debt was unsustainable and (ii) the member was implementing a Fund-supported program or was actively negotiating such a program. There are a number of ways in which the Fund's formal role in the activation of the stay could be reduced.

29. One alternative would be to empower the majority of the sovereign's creditors to activate the stay. Such an approach would mimic, to an extent, the enforcement provisions of collective action clauses found in many international sovereign bonds.

These provisions effectively enable a qualified majority of bondholders to prevent a minority from pursuing any legal action against the sovereign during the negotiations of a debt restructuring agreement.[3] Reliance on such an approach would serve to highlight the extent to which the problem being addressed by the mechanism is one relating to inter-creditor equity and coordination.

30. An important shortcoming of this approach is that, even if the requisite majority of the creditors were amenable to approving a stay that would be binding upon the entire creditor body, it could take considerable time to put one in place. In the context of a single bond issue where provisions exist that enable the majority of creditors to prevent enforcement by a minority, the process of ascertaining the will of the majority is relatively straightforward. In contrast, a vote by all creditors (all bond issuances, bank debt, trade credit, certain official claims) as envisaged under the mechanism would need to be preceded by a verification of claims process that might take several months to complete.

31. As a means of addressing the difficulties of organizing creditors while reducing the role of the Fund in the operation of the mechanism, consideration could be given to an alternative approach that enabled the sovereign to activate the mechanism unilaterally and enjoy the resulting legal protection for a limited 90-day period. At the end of that period, claims would have been verified and creditors would vote as to whether the stay would be extended and, if so, for how long.

32. If such an approach were to be followed, a key question would be whether the ability of the sovereign to activate the mechanism for a limited period might be abused by members whose debt was not judged to be unsustainable. In most cases, it can be expected that that a member would only activate the mechanism in consultation with the Fund, i.e., after the Fund had determined that the debt burden was unsustainable and that further financial assistance would not be forthcoming in the absence of a restructuring. Nevertheless, there is a risk that a purely unilateral stay—even one that expired after a limited amount of time—could be subject to abuse.

33. In light of these concerns, two alternative approaches to activation could be considered. The first approach would require Fund approval of the stay for an initial period (e.g., 90 days) in order for it to be effective. Debtors could suspend payments, but legal protection during the payments suspension would require the endorsement of the Fund. Any extension of the stay beyond this initial period would require the consent of a majority of creditors.

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[3] Upon an event of default, most international sovereign bonds provide that an acceleration (where the full amount owing becomes due and payable) may be blocked by a defined percentage of bondholders. In addition, international sovereign bonds issued under trust deeds (traditionally governed by English law) give the trustee the primary authority to initiate legal action, and the trustee is only permitted to do so if such action is supported by a threshold percentage of bondholders.

34. The second approach would be to delay the activation of the stay until it was approved by the requisite majority of creditors. Since it would normally about three months for the claims of creditors to be verified and for a vote to take place, this approach would mean that there would be no possibility of a stay immediately following the member's request. Notwithstanding this delay, the possibility of a stay being imposed after the expiration of this initial period may deter litigation at the outset, since potentially disruptive creditors may feel that they may not be able to obtain a judgment and attach assets prior to the imposition of the stay.[4] Moreover, this initial three-month period could be reduced substantially if creditors established their own procedures that facilitated a more rapid claims verification and voting process. For example, a standing organization might be established whose role would include registering claims against the sovereign and facilitating the organization of creditors in the context of a restructuring.

35. A brief delay between the member's suspension of payments and the activation of the stay would not leave a sovereign helpless in the event that the suspension gave rise to capital flight. When necessary, a member will always be able to impose capital controls to stem outflows and, depending on the circumstances, such controls may be a necessary—but temporary—feature of a Fund-supported program.

Maintenance of the stay

36. Under the approach outlined in the Initial Note, the stay would only be maintained if the Executive Board determined that: (i) the member continued to implement appropriate policies; (ii) the member was making progress in its negotiations with creditors; and (iii) was refraining from taking actions that would prejudice the interests of its creditors generally. Following the analysis set forth in the previous section, the majority of creditors might be given the authority to determine whether to extend the stay beyond the initial 90-day period. By that time, the claims of creditors would have been verified, and creditors would be in a position to vote on the issue. If the member was already in a position to submit a restructuring plan for approval at the expiration of this initial period, the creditors would vote on the proposal, and an affirmative vote by the requisite majority would bind dissenting creditors. If, however, more time were needed for negotiation, creditors would decide (again by a vote of the requisite majority) whether the stay should be extended and, if so, for how long.

37. Although the Fund would not have the legal authority to extend the stay, the decisions it would make regarding the availability of its resources would have a major impact on whether an extension would be approved by creditors. Specifically, the requisite majority of creditors would normally only be willing to extend the stay beyond the initial period if they had some assurance that the member was adopting policies that were being supported by the Fund. When making a decision to extend the stay, the majority of creditors would be in a position to judge whether the member was negotiating with them in good faith and protecting their interests.

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[4] The opposite argument could also be made that it would encourage accelerated enforcement of earlier judgments.

38. Would such an approach give creditors too much leverage in the process? As noted above, the concept of a stay being imposed upon all creditors through a decision by a majority is roughly analogous to the majority enforcement provisions that are found in many international sovereign bonds. Such provisions make it impossible to initiate litigation without the support a given percentage of the bond issue, and thus allow the requisite majority to block legal action by a minority. As noted earlier, however, while such provisions bind the bondholders within the same issuance, an affirmative vote by the majority under the proposed statutory framework would bind the entire creditor body.

39. There may be a risk that creditors would withhold an extension of the stay in the hope that the Fund would provide more financing or call on the member to make additional adjustment efforts. For example, even in circumstances where the member is implementing good policies and negotiating in good faith, creditors may refuse to extend the period of the stay as a means of persuading the member to turn to the Fund for financing that could enhance the terms of any restructuring. The creditors could threaten to lift the stay to force the debtor to agree to more adjustment than contemplated under the Fund-supported program. Such risks could be reduced, however, by the resolute application of the Fund's policy of lending into arrears, under which it signals its willingness to continue to support a program, provided additional finance comes from the private sector, if necessary through the mechanism of arrears to private creditors.

IV. Legal Basis

Contractual vs. statutory basis

40. As discussed above, the decision-making process under the mechanism could, to a large extent, resemble features of the collective action clauses found in international sovereign bonds. Decisions regarding both the terms of the restructuring and the activation and maintenance of the stay would be made by the requisite majority and would be binding on the dissenting minority. Notwithstanding this important similarity, there are a number of reasons why the legal basis for the mechanism would need to be based on a formal statutory regime. A contractual approach that relied upon the progressive adoption of bond covenants that facilitate majority action could help improve the debt restructuring process, but there are also limitations on what it can achieve.

41. First, there is the problem of incentives for the adoption of contractual provisions in new bond issues. By definition, a contractual approach would require the sovereign and its creditors to agree to the inclusion of these provisions in all future international sovereign bonds, and also in other debt and debt-like instruments that the market developed. As noted in the Initial Note, recent experience demonstrates that sovereign debtors actually prefer to exclude such provisions as a way of demonstrating their firm intention to avoid a restructuring. Moreover, notwithstanding the fact that their presence may make an unavoidable restructuring more prompt and orderly, creditors have traditionally not clamored for their inclusion. The advantage of giving the framework for sovereign debt restructuring a statutory basis is that the collective action provisions that it

would contain would effectively override the restructuring and enforcement terms set forth in the underlying agreements, as is the case with the collective action provisions contained in domestic insolvency laws.

42. Second, as stated in the Initial Note, there is a transitional problem. Even if all new bonds make use of the needed contractual provisions, a large portion of outstanding bonds with long maturities, including bonds governed by New York law, do not contain such provisions. While this problem could conceivably be addressed by a series of exchanges that retired existing bonds, it is not clear how debtors and creditors would be persuaded to take such action. It is also possible that use could be made of existing provisions that allow for amendment of nonfinancial terms to facilitate debt restructurings in the interim. For example, Ecuador recently made use of "exit consents," to overcome the problem of holdout creditors generated by the absence of provisions allowing a majority to amend financial terms in outstanding bonds governed by New York law. Under this technique, bondholders who accepted the exchange voted to amend nonfinancial terms in ways that made holding "old bonds" less attractive. However, this technique has been somewhat controversial and it may not be immune from legal challenge in the future. For a discussion of "exit consents," see EBS/02/15, January 31, 2002 (*Involving the Private Sector in the Resolution of Financial Crises—The Restructuring of Sovereign Bonds—Further Considerations.)*

43. Third, and perhaps most importantly, collective action clauses traditionally only bind bondholders of the same issue. In contrast, the collective action provisions of a statute would be designed to apply to across all indebtedness, i.e., international and domestic debt, bank loans, trade credit and official claims, if applicable. This is one of the reasons why the collective action provisions of insolvency laws are so effective. To address issues arising from the relative seniority of certain indebtedness, insolvency laws often provide for the classification of debt for both voting and distribution purposes.

44. To allow for majority action across a wider set of instruments, one could conceive of the introduction of contractual provisions that provide for the restructuring of the instrument in question on the basis of an affirmative vote of creditors holding a qualified majority of all private credits. On close examination, however, such an approach would be difficult to implement for a number of reasons.

45. First, if it is difficult convince a sovereign and the purchasers of one bond issue to agree to the inclusion of a collective action clause in that issue, it would be even more difficult to persuade debtors and creditors to include such provisions in *all* forms of debt instruments in a uniform manner. Indeed, a sovereign facing financial difficulties would come under pressure from certain creditors to exclude such provisions as a means of giving such creditors effective seniority. Moreover, it can be expected that certain creditor groups would be particularly reluctant to agree voluntarily to an arrangement whereby, for voting purposes, their claims were aggregated with all other present or future creditors.

46. Second, even if all debt instruments contained identical restructuring texts, which would be difficult to achieve, there would be no assurance of uniform interpretation and application unless they were governed by the same law and subject to the same jurisdiction.

47. Third, it may not be feasible to establish a process by contract that would effectively guarantee the integrity of the voting procedure. Under the statutory framework that governs the domestic insolvency process, a court oversees this process, including the verification of claims, so as to guard against fraud. In the absence of an independent party to verify the true value of claims, a debtor could, for example, inflate its debt stock by establishing matching credit and debt positions with a related party. That entity—which could hold a qualified majority of all debt—could vote to reduce the value of all creditor claims.

48. Fourth, it is not clear that such provisions would be consistent with the existing legislation of all members. As discussed in an earlier paper that analyzed the current use of collective actions,[5] the fact that such provisions are not included in international sovereign bonds in at least two key jurisdiction arises, in part, from the absence of a clear statutory basis that allows for the rights of a minority of creditors to be modified without their consent.

49. Finally, and more generally, the financial markets have consistently demonstrated the ability to innovate. A statutory regime is therefore likely to provide a more stable background than contractual provisions even if it were feasible to overcome all of the other difficulties referred to above.

50. Recognizing the limitations on what can be achieved through contractual innovation does not undermine the case for increasing the use of collective action clauses. Indeed, until a statutory basis for a collective action framework is established, the introduction of such clauses in international bonds provides an important means of facilitating the orderly restructuring of external debt.

The advantages of an international treaty

51. If a statutory approach that creates the legal basis for majority action across all sovereign indebtedness offers the best method of achieving the objectives of a sovereign debt restructuring mechanism, the question arises as to how best to implement a change in the statutory regime.

52. As discussed in the Initial Note, there are a number of reasons why the statutory approach could be more effectively implemented through the establishment of universal treaty obligations rather than through the enactment of legislation in a limited number of jurisdictions. First, it would prevent circumvention: if the statutory framework is only in place in a limited number of jurisdictions, creditors could ensure that future instruments

[5] Involving the Private Sector in the Resolution of Financial Crises—Collective Action Provisions in International Sovereign Bonds (SM/99/207).

enable them to enforce their claims in jurisdictions that have not adopted such jurisdictions but whose money judgments are recognized in key jurisdictions under treaties or local law.[6] Second, an international treaty would ensure both uniformity of text and (if there is an institution given interpretive authority) uniformity of interpretation. Third, it would address a potential "free rider" problem: without a treaty, countries would be reluctant to adopt legislation until they were assured other countries had also done so. (Under a treaty, the provisions would enter into force for all countries at the same time). Finally, the establishment of a treaty facilitates the establishment of a single international judicial entity that would have exclusive jurisdiction over all disputes that would arise between the debtor and its domestic and international creditors and among such creditors. Moreover, such an entity would also have responsibility for the administration of a unified voting process, including the verification of all creditor claims. If one relied exclusively on domestic legislation in a variety of jurisdictions, the process for dispute resolution and claims verification would be fragmented one, with different claims being subject to the jurisdiction of different courts, depending, inter alia, on the governing law of the instrument.

53. While there would be certain advantages to establishing universal treaty obligations through an amendment of the Articles, such an approach would raise difficult institutional issues. In terms of the advantages, an amendment of the Articles can be made binding upon the entire membership once it is accepted by three-fifths of the members, having 85 percent of the total voting power. Moreover, given the considerable benefits of Fund membership, it is very unlikely that a member would wish to opt out of the mechanism in the future.

54. It should be emphasized that, if an amendment of the Articles were to merely to provide the legal basis for the "majority action" decisions, as described in the alternative approach discussed in the earlier section, it would not give the Executive Board any additional legal authority. Rather, it would give a majority of creditors the legal authority to bind a dissenting minority.

55. If such an approach were followed, an important outstanding issue would be the nature of the process for the verification of claims and resolution of disputes. As was discussed in the Initial Note, the Fund's existing institutional infrastructure would not accommodate it playing such a role. As a creditor, the Fund would not be impartial and, moreover, it would have limited expertise in these technical matters.

56. There would appear to be two alternative means of addressing this issue.

57. The first alternative would be to establish a separate treaty that would create a new institution to perform this role. Given the central role that the Fund would play in the mechanism with respect to its financing, one could envisage this treaty establishing an "affiliated" institution (analogous to the relationship between the World Bank and its

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[6] Overriding the recognition of judgment would require uniform recourse to the "public policy" exception to these general rules

affiliated organizations). The drawback of this approach is that, in order for such a treaty to achieve its objectives, it would have to be ratified by all members.

58. The second alternative, which was discussed in the Initial Note, would be to rely on the same amendment of the Articles that would be used to establish the collective action framework, described above, as the basis for establishing a new judicial organ that would carry out these very limited functions. During the discussion of this latter alternative, several Directors enquired as to whether there would be adequate safeguards to ensure that such an organ operated—and was perceived as operating—independently from the Executive Board and the Board of Governors.

59. As a legal matter, the independence of the organ would be established by the text of the amendment itself. The amendment would provide that decisions of the judicial organ would not be subject to review by any of the Fund's other organs and that, more generally, the judges appointed to this organ would not be subject to the interference or influence of the staff and management of the Fund, the Executive Board or any Fund member. The text of the amendment could also specify in some detail the qualifications of the judges to be selected and, to ensure security of tenure, the grounds for their dismissal. One way of ensuring that the judges serving on the organ maintain some distance from the staff and the Executive Board would be to appoint them for a limited but possibly renewable period.[7] Moreover, a procedure could be established whereby the judges appointed by the Managing Director (or the Board) would be derived from a list of candidates that would have been selected by a qualified and independent panel.

60. It should be emphasized that the role of this judicial organ—wherever it is located—would be a limited one. Specifically, the organ would have no authority to challenge decisions made by the Executive Board regarding, inter alia, the adequacy of a member policies or the sustainability of the member's debt.

V. The Application of the SDRM to Exchange Controls

61. In the context of financial crises, exchange controls may need to be relied upon in at least two circumstances. First, in circumstances where a sovereign defaults on its own indebtedness, it is possible that such a default will trigger capital flight, particularly where the restructuring will also embrace claims on the sovereign held by the domestic banking system and the member maintains an open capital account. Second, even where the external debt of the sovereign is not significant, a financial crisis can arise because of the overindebtedness of the banking and corporate sectors which, when coupled with a loss of creditor confidence, leads to a sudden depletion of foreign exchange reserves. As a means of addressing this crisis, it may be necessary for the authorities to impose exchange controls for a temporary period.

[7] However, purely *ad hoc* appointments—where they are only retained during the period of the restructuring—could actually undermine their independence or perceived impartiality.

62. In some cases it may be possible to design the exchange controls in such a way that they arrest capital flight without an interruption in debt service and other contractual obligations. In other cases, however, the exchange controls may interrupt debt-service payments by residents to nonresidents. While this may be unavoidable, it would be important for the authorities to put in place a framework for the eventual normalization of creditor relations by nonsovereign debtors, in order to minimize the long-term impact on corporations' market access. Such a framework could include two key features. First, the facilitation of an out-of-court workout mechanism operating in the shadow of domestic bankruptcy. Second, a specification of the minimum terms under which foreign exchange would be made available to service restructured debts. The question arises, however, as to whether an SDRM should be designed to provide limited legal protection (in the form of a stay) during the period of renegotiation to domestic enterprises that might otherwise be subject to litigation as a result of the default arising from the imposition of controls.

63. It should be noted at the outset that, even if the decision were made to exclude nonsovereign debt from the coverage of an SDRM, exchange controls would still provide considerable legal protection in at least two respects. First, any restrictions imposed on the ability of residents or nonresidents to make transfers abroad (or, in the case of nonresidents, repatriate amounts) would still be enforceable within the territory of the sovereign. Second, in the event that the controls give rise to payments arrears, foreign creditors would be precluded from enforcing their claims against a resident debtor in the territory of the sovereign. The legal protection that may *not* be provided by the controls would be protection against the enforcement of claims by nonresidents with respect to a resident debtor's assets that are located overseas. It is this latter category of protection that an SDRM could be designed to provide.

64. The possible application of an SDRM to exchange controls raises a number of difficult issues. Among them is the feasibility of making a distinction between those debtors that, except for exchange controls, would be able to service their debt, and other debtors that are not healthy and need to be restructured. While it would be reasonable for the former category to enjoy some temporary legal protection under an SDRM, it would be preferable to make the latter category subject to the local insolvency law. A second difficulty relates to the protection of creditor interests: during the period of the stay on litigation, what measures could be put in place that would give creditors the assurance that the shareholders of the debtor are not using the stay as a means of facilitating asset stripping?

65. A final question relates to the role of the Fund. As discussed above, in the context of sovereign indebtedness, it is possible to design a framework where the key decisions are made by the majority of creditors rather than the Fund. However, in the context of exchange controls that gives rise to the default of a multitude of debtors (each with their own group of creditors), such an approach would not be feasible. In these circumstances, the legal authority to approve a temporary stay, if that were deemed an eventual feature of a new statutory mechanism would need to reside with the Fund. It should be noted that the existing Articles already give the Fund limited authority in this area. Specifically, as interpreted by some – but not all - jurisdictions, Article VIII,Section 2(b) stays creditor

enforcement on arrears arising from exchange controls that are consistent with the Fund's Articles.

VI. Future Work Program

66. The design of an SDRM is part of a broader reassessment of the Fund's approach to the resolution of financial crises in emerging market economies. Two other crucial topics, access policy for capital account crises and the analytical basis for judging debt sustainability, are being addressed in separate papers. As noted above, decisions about access and judgments regarding debt sustainability will play a crucial role in the operation of a sovereign debt restructuring mechanism. In addition, the staff will continue to explore approaches within the existing institutional framework that might alleviate the problems addressed by the SDRM.

67. There are a number of issues relevant to the design of a sovereign debt restructuring mechanism that need to be explored further in future papers. These include:

- *Creditor Coverage*. Credit from the Fund and the multilateral development banks would not be subject to a sovereign debt restructuring mechanism, because of their status as preferred creditors. Although guidelines and procedures already exist for the restructuring of official bilateral debts (through the Paris Club), those guidelines might need to be modified in the event of the establishment of a sovereign debt restructuring mechanism. Other issues that need to be addressed are the relative treatment of domestic and external debt, secured and unsecured creditors, and, more generally, the criteria to be utilized for classifying creditors for voting and restructuring purposes.

- *The application of a SDRM's legal protection to nonsovereign debt and the role of exchange controls.* This paper will need to consider: (i) whether temporary exchange controls will be needed when a sovereign is using an SDRM to restructure its debt; (ii) the appropriate scope of the exchange controls; and (iii) whether the SDRM should provide temporary protection to nonsovereign debtors and, if so, how to ensure that the stay on litigation only protects healthy enterprises, who are unable to pay their debts solely because of the imposition of exchange controls (i.e., does not block or delay domestic insolvency proceedings for unhealthy firms).

- *Mechanisms for the provision of senior private financing*. This paper will need to consider whether and how to assure the seniority of new private financing for the sovereign, how to determine its appropriate level, what linkages there should be, if any, between the provision of Fund financing and senior private financing, and the relative standing of senior private financing and financing from preferred creditors. The role of the sovereign in ensuring that the domestic private sector has access to trade credits, particularly, if exchange control are in place, should also be considered.

- *Protecting creditor rights and asset values during the period of the stay*. This paper will need to include a discussion of the effects of the stay on both the debtor and its creditors, the rules the debtor would be expected to abide by as a condition for the maintenance of legal protection, such as prohibitions on making payments to favored creditors, and the remedies available to creditors, including lifting the stay, if the debtor takes action against the general interest of creditors.

- *Dispute resolution.* This paper would consider the nature of the dispute resolution process under a sovereign debt restructuring mechanism and, in particular, a discussion of the role and composition of the judicial organ that would be established under an amendment of the Fund's Articles.

- *The implications of a sovereign debt restructuring mechanism for the HIPC process*. Since the bulk of the debt of heavily-indebted poor countries is held by the official sector, which has agreed to give debt relief in the context of the enhanced HIPC initiative, it is not expected that it would be to the advantage of such countries to seek a restructuring under the SDRM. Nevertheless, the existence of the SDRM may have implication for private claims upon HIPCs, and some aspects of HIPC procedures may need to be re-evaluated in light of the SDRM.

VII. Issues for Discussion

- Directors may wish to express their views as to whether a mechanism that includes the four key features described in the paper would make the sovereign restructuring process more orderly, prompt, and predictable?

- How do Directors view the importance of the Fund's judgment that the member's debt is unsustainable in the member's having access to the protection offered by the SDRM?

- How do Directors see the balance of risks and benefits to a reduced Fund role in the operation of the mechanism, as described in this paper. Directors may wish to express their views on the advantages and disadvantages of such an approach in the context of the various stages of a mechanism's operation, i.e., the activation of the stay, its maintenance, and the approval of the restructuring agreement.

- Do Directors agree that the Fund's decisions on the use of its resources influence the restructuring process appropriately both in current circumstances and under an SDRM?

- The paper identifies a number of advantages of making the legal basis of a mechanism statutory rather than contractual. Do Directors agree that a statutory approach would be preferable?

- The paper notes that, even if the role of the Fund in the operation of a sovereign debt restructuring mechanism is limited, an effective way of achieving it would be

through an amendment of the Fund's Articles of Agreement. Directors may wish to comment.

- If an amendment of the Fund's Articles of Agreement is to provide the legal basis for a debt restructuring mechanism, a unified dispute resolution process will need to be established. The paper discusses the possible merits of establishing an independent judicial organ for this limited purpose. Do Directors agree with such an approach?