© *The Financier* • Vol. 9, Nos. 1-4, 2002
http://www.the-financier.com

Sovereign Debt Restructuring

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In light of the present difficulties surrounding the efforts of Brazil to restructure its $264 billion debt burden, the Derivatives Study Center, with the New Rules for Global Finance coalition, has drafted the following Primer to help clarify the key issues in the policy debate over the formation of a more fair, transparent and orderly procedure for allowing developing countries and their lenders to restructure outstanding debts.

I. INTRODUCTION

Debt has been the largest source of capital flows to developing countries in the past 50 years. Lending increased drastically starting in the 1970s, and today the total external indebtedness of developing countries at the end of 1999 amounted to $2.6 trillion – representing about 42.5% of their GDP that year. Of this total, the long-term foreign debt owed or guaranteed by governments is $2.2 trillion or 75% of all long-term debt. [1]

Despite the transfer of resources that were afforded by these immense capital flows, economic development has not been widely successful and even where it has occurred the process has not been a smooth one. Today there is an important ongoing debate about the causes and consequences of this lending. Irrespective of the outcome of the debate over whether such borrowing has been useful, it remains a fact that the debt build-up has led to repayment problems and in some cases default. The current framework for addressing default, bankruptcy and debt restructuring[2] has proven to be inadequate in sorting out these problems. These shortcomings are now widely appreciated, and there are several efforts underway to establish a new and more effective restructuring process. This memo attempts to give an overview of the current policy debate on the sovereign debt restructuring process. There is a long history of sovereign debt problems and crises, and it includes more than the developing world. During the Great Depression of the 1930s, both the U.K. and France defaulted on their debts in favour of the needs of their peoples. But it is Latin America that is most associated with debt payment problems, and these can be dated back to 1914 when Mexico suspended its debt payments. In 1956, with a debt problem looming over Argentina, a group of wealthy industrialized nations met in Paris to develop a solution to problems in Argentina. This led to what is now known as the Paris Club. Since the first case involving Argentine in 1956, this informal arrangement called the Paris Club has reached 347 agreements concerning 77 debtor nations.

In the wake of the vast increase in lending in the mid-1970s, a series of well publicized debt crises swept through the developing world starting with Mexico in August of 1982. This decade came to be known as the "lost decade" because of the lack of economic growth in the region. The next stage of development in debt restructuring process was the creation of Brady Bonds[3]. A large amount of the lending to Latin America in the 1970s had been in the form of syndicated bank loans, and the Brady plan proposed exchanging the loans for bonds that would allow the debt to be traded in financial markets where it would be priced at market value. The value of Brady Bonds was enhanced by the use of U.S. Treasury securities to guarantee part of the interest and principal payments. In December of 1994, the "Tequila Crisis" started in Mexico and spread through Latin America and into other parts of the developing world. A subsequent crisis followed with the East Asia in 1997-8, then Russia defaulted in 1998, Turkey came next in 2001, and then the biggest sovereign default in history occurred when Argentina defaulted on $141 billion of public debt in 2002.

Throughout this debt crisis prone period there were many efforts to restructure sovereign debts, and each effort was a problem in itself. This problem became greater with the introduction of bond lending. Whereas the restructuring of official debt and syndicated bank loans involved sometimes dozens of lenders, the introduction of bonds expanded the credit base to involve hundreds if not thousands of creditors. One particular aggravation was the emergence of Vulture Hedge Funds that would buy distressed sovereign debt on the secondary markets and then sue for full-repayment once restructuring negotiations commenced.

The most notable case of a vulture hedge fund was that of Elliot Associates (a small New York-based investment fund). In October 1995, Peru announced a Brady restructuring of its debt in the context of an IMF-supported program. Over a year later, Elliot Associates purchased $20.7 million of commercial loans that had been guaranteed by Peru and earmarked for a Brady exchange. Elliot Associates subsequently sued Peru for the full value of the debt and after an initial loss in a New York court won the case in the Federal Court of Appeals for the full value of $58 million. Facing a court seizure on its Brady Bond repayments, Peru eventually paid in full in October 2000.

Despite the particularly egregious problem with vultures, there has not emerged a clear strategy for how to manage debt restructuring once a crisis begins to take shape. With all the latest developments in the financial marketplace around the world, this is a glaring shortcoming and there is now a widespread interest in establishing a coherent framework for this process.

II. DEBT ACCUMULATION AND HIPC

According to the World Bank's Debtor Reporting System, the total external debt of low-income developing countries[4] — the poorest countries in the world — reached $572 billion in 1999. Most of this is owed by the governments of those countries; in 1999 the government's owed or guaranteed 87.3% of long-term external debt or 77.8% of all external debt. The $572 billion in debt amounts to 57% of the GDP of those economies in 1999, on which the total debt service is $47 billion or 4.7% of GDP.

In the context of indebtedness the IMF and World Bank jointly launched the "Heavily Indebted Poor Countries Initiative" (HIPC) in 1996. Its aim was to provide debt relief for countries who face unsustainable debt burdens and agreed to follow IMF and World Bank programs. The HIPC initiative requires the involvement of all creditors and the commitment from the debtor country that it continue towards macroeconomic structural adjustment and social policy reforms deemed satisfactory by the IMF and World Bank. As part of the initiative, additional finance is provided for social sector programs such as basic health and education programs. At present the HIPC initiative will potentially extend to 41 countries, and as of March 2002, only 26 had reached their "decision points" and have qualified for debt reductions. According to the IMF, the 26 qualified countries' packages will eliminate $40 billion in debt or half of what they owe. This will reduce debt service by 30% compared to the 1998-9 period, and this will amount to about 14% of government revenue (slightly more than half the 1998-9 share).[5]

III. PROPOSALS FOR SOVEREIGN DEBT RESTRUCTURING

While there is widespread agreement for the need for a sovereign debt restructuring process, there is also disagreement over what the actual process should be. A successful framework will need to involve negotiation and eventual agreement between the debtor and the creditors. A framework will also need to protect the rights of creditors and debtors; it is especially important that debtors be protected from civil law suits during the structuring process. There is a broad agreement that the process should prevent rogue vulture hedge funds from delaying or otherwise disrupting the restructuring process and from profiting from others' efforts to forgive and restructure outstanding debt.

Many individuals and institutions have put forth proposals for such a process, but there are really only three basic approaches. One proposal from the IMF calls for the creation of an institution to act as an arbiter in a new formalised process which would work along the lines of an international bankruptcy court. The principle author of this proposal is Anne Krueger and it is known as the Sovereign Debt Restructuring Mechanism (SDRM). Another proposal from the U.S. Treasury advocates the use of "collective action clauses" in debt covenants to allow a majority of creditors to set the terms of restructuring. A third proposal, from Kunibert Raffer, and others[6] adapts U.S. sovereign bankruptcy laws, known as "Chapter 9", to the needs of developing countries.

IV. SOVEREIGN DEBT RESTRUCTURING MECHANISM

There are four "core features" to Krueger's SDRM proposal: majority rule (as opposed to unanimity) in restructuring decisions, a legal "stay"[7] against claims by creditors, protection of creditor interests, and priority financing.[8] Majority restructuring would mean the creation of a mechanism that allows a qualified majority of creditors to bind in a dissenting minority to the terms of a restructuring agreement.[9]

A stay on creditor enforcement would allow the debtor to get a "stay" from creditor litigation if an agreement could not be reached prior to a default; this would essentially create a window for further negotiations.[10] From a different angle it could act as an incentive for creditors to come to a collective agreement so that a stay is not invoked. The interests of the creditor will need to be protected during the period of a stay and would take two forms: the debtor nation would not be allowed to deal with non-priority creditors; and the debtor would be prohibited from adopting policies that would be detrimental to "asset values." The debtor will need money during the stay and this is where priority financing comes in. It is in both the debtor's and creditors' interest for the debtor to have money to help it through the interim period so as to "limit the degree of economic dislocation and thereby help preserve the member's capacity to generate the resources for meeting debt-service obligations"[11] and also cover such things as trade credit. The provision also allows for this new money, provided by creditors, to be treated as senior to any pre-existing debt.

Krueger's proposed framework requires both a statutory change as well as the creation of a new institution that would act as an intermediary in discussions between the debtor and creditors. This new institution, called the Dispute Resolution Forum (DRF), will act as the single and exclusive entity to resolve debt issues between the debtor and creditors, as well as between creditors. The DRF will be set up by the IMF, but exist somewhat independently of that body. This statutory change would amount to a treaty obligation and it is proposed that this be achieved through an Amendment to the IMF's Articles of Agreement. A treaty, or change to the Articles, would ensure a universal legal framework.[12]

The setting up and operation of the DRF would be guided by four basic principles: independence, competence, diversity and impartiality; and there is an elaborate 5-step procedure for this to be achieved.[13] At the basic level, each of the 183 IMF members will have the opportunity to nominate a candidate for the DRF. Out of this list 21 members will be chosen to serve terms (recommended at 4 to 5 years), and these members would, amongst themselves, chose a "Presiding Member." The group would then be permanent members of the DRF, and at the request of a debtor nation an SDRM process would be enacted and the Presiding Member would "impanel" 3 members to work as part of the SDRM. The DRF's role would be to interpret and apply the framework for an SDRM; it would not be judge and jury but just an arbiter in the process. The acceptance of an agreement will depend upon majority vote by creditors, and therefore the "certification" of the process would not be based on the panel's discretion.[14]

Another part of the proposal, which may be included as part of the DRF's role, is the setting up of a permanent sovereign claims registry that would register all claims on a sovereign entity (essentially a debt stock-taking endeavour). At present, this is a voluntary feature of the proposal, but it is potentially very useful. For example, Costa Rica saved almost 10% of the interest in arrears when it performed a verification loan-by-loan in the early 1980s.[15]

V. COLLECTIVE ACTION CLAUSES: THE TREASURY PROPOSAL

A second approach is to require collective action clauses for loan and bond covenants. One of the principle authors is U.S. Treasury Undersecretary John Taylor, but it is also supported by such noted economists as Barry Eichengreen (2002). It focuses on the writing of bond and loan contracts to include clauses that would prevent a minority of creditors from blocking negotiations with the debtor. Taylor (2002) refers to this as a decentralised market-oriented approach, as opposed to the centralised non-market approach of SDRM.

Collective action clauses (CACs) would bind in a minority, and therefore any vulture funds, and allow a majority vote (usually a super-majority of 60% to 75%) to determine the outcome of a restructuring agreement.

The principal shortcoming with this approach is that CACs can only be included in future debt, and the enormous amount of currently outstanding debt would not benefit from their inclusion. Only after the entire current stock of debt is repaid or rolled-over will the CACs be included and serve their intended purpose. If even a small fraction of the debt is contracted without CACs (thus requiring all creditors agree unanimously to any restructuring), then the CACs cannot by themselves solve the problem. In this regard they will not successfully function as a solution to the problem until after they are universally employed in bond and loan contracts and this may take 10 years or more.

Moreover, private lenders are not presently voluntarily including them in their new debt contracts. Do they need additional incentives to act in what Taylor says is their own self-interest?

Taylor (2002) acknowledges that debtors and creditors are reluctant to include CACs in current issues, which is referred to as "drafting inertia" by Buccheit and Gulati (2002), but argues that recent empirical work suggests existing difference in clauses has little impact on the attractiveness of bonds on the buy-side. Nonetheless, the view from the debtor, or sell-side¸ is that these clauses would cost additional basis-points to a debt issue. Even if CACs are employed in all new debt issuances and this effectively creates a new universal legal framework, there will still will not necessarily be a uniform interpretation; debt is typically issued in a number of jurisdictions and it will be up to individual jurisdictions to interpret the clauses, if enacted, according to their domestic law.

The inclusion of CACs could be encouraged by making them a requirement for any country seeking IMF funding, or alternatively, it would serve as the basis for lower borrowing costs on loans from the IMF. Krueger, however, fears that this would come at a time when the private sector would not want to lend to a nation and the inclusion of clauses would not be helpful.

VI. CHAPTER 9 PROPOSAL OR FTAP PROPOSAL

The third proposal for a better restructuring framework proposes that Chapter 9 of U.S. bankruptcy law be applied internationally to sovereign debt. [16] There are several versions of this approach although they are on the essential points. The principle authors include Kunibert Raffer, Jurgen Kaiser and Jubilee Research which agrees that it gives the debt resolution process a "human face."

Raffer (1990) explains how Chapter 9 functions in the U.S. to protect the rights of indebted municipal governments and public agencies in order to protect the rights of taxpayers and public sector employees, and allows for their full participation in, and ability to object to, the outcome of a debt rescheduling process.[17]

Raffer proposes that Chapter 9 be adopted internationally to allow an indebted nation to file for a stay. According to this plan, the petition for and judgement on the stay will be deemed by the nation itself, and not the IMF, because every nation will be unequivocally entitled to a stay if requested. As with the SDRM proposal, there will need to be a third party body to be put in place to resolve the conflict between the debtor and creditors. Unlike the permanent DRF, this body is proposed to be ad hoc, appointed with each petition for a stay, and also is to act as arbitration panel. The panel, under the oversight of the UN, would be composed of one or more members appointed by the debtor, plus an equal number appointed by the creditors, and an n^{th} member chosen by the other members of the panel so that the panel has an odd number of members.

The ad hoc panel will then act as a typical bankruptcy court with the exception that, as with Chapter 9 US bankruptcy law, citizens of the debtor nation will have the right to be involved in this process and object to any agreement.[18] In a version of the sovereign registry in the SDRM proposal, the Chapter 9 proposal specifies that the court will judge whether debts were contracted legitimately or were the product of reckless borrowing by corrupt government officials and similar style lending by creditors.

This approach would require only minor statutory changes. Raffer (2000) points out that the majority of sovereign debt is already governed by New York and British law (actionable in U.S. or British courts) and thus there need be only small changes to U.S. and U.K. laws governing sovereign immunities. These changes would amount to the inclusion of a clause that would suspend the waiver of immunity the immunity of sovereign debtors once the restructuring negotiations had commenced.

Under the proposed Chapter 9 process, arbitration is done through the ad hoc body with a majority of creditors binding all creditors in a collective action clause type of provision.

Chapter 9 would put much more responsibility in the hands of the debtor nation. In the anticipation of debt payment problems, it would be up to the debtor nation to attempt to negotiate a debt restructuring with creditors. If this is not successful, the nation can petition for, and be granted, a stay.

Although there is a worry, on the IMF's front, that solvent nations might be attracted to a debt restructuring if they have the ability to do so, it is unrealistic, in the same way with a corporation, that any country would see medium or long term benefits from going through an insolvency process as it would taint a country and limit access to capital.

The stay on debt payments would protect the debtor nation from creditors and the IMF until the independent panel is formed. Once the panel is set up, it would then hear the petition and if legitimate enact court proceedings. Once in session, the panel would evaluate whether debts were properly and legally contracted, which would mean that every loan would have to be assessed. The Chapter 9 process would protect the human rights of the nation's citizens by preventing the debtor country from raising debt payment revenue by destroying basic social services and it would require that funds for a sustainable economic recovery be set aside. The panel would have to bind the debtor and all creditors to a final restructuring plan, but this plan does not necessarily have to be an IMF Structural Adjustment Program; representatives of the taxpayers and government employees would then be able to comment on the plan.

ENDNOTES

[1] World Development Indicators 2001, Table 4.16, External Debt.

[2] The term restructuring is used to include the rescheduling of interest and principal payments as well as a write-down on the debt principal or interest rate.

[3] Brady Bonds were named after the former US Treasury Secretary Nicholas Brady who led the debt reduction plans for the LDCs.

[4] The World Bank breaks the developing world down into low-and middle-income countries (and lower middle income and upper middle income). See World Development Indicators 2001 for the classification of "low-income" and "middle-income" countries.

[5] IMF (2002).

[6] See J. Kaisser, Jubilee Research and Jubilee 2000..

[7] A stay is sometimes referred to as a "debt standstill." It prevents creditors from suing in court to seize the assets of the debtor during the restructuring process.

[8] This allows new debt to be treated as senior to outstanding debt and thus encourages new lending.

[9] Krueger has stated that this would be "the most important element of any restructuring element."(Krueger (2002a, p. 14).

[10] The IMF has not decided whether a debtor can make a stay, even if temporary unilaterally or whether the IMF or a majority of creditors would first have to approve it.

[11] Krueger (2002a, p.17).

[12] A vote of 85% of the shares and 60% of the members is required to amend the articles of the IMF.

[13] See Krueger (2002b) for details.

[14] This is only a brief summary of the process described by Krueger (2002b).

[15] Bogdanowicz-Bindert (1985) p145, taken from Raffer (1990) p309.

[16] For the purpose of space we are dealing with FTAP, "Fair and Transparent Arbitration Process", as proposed by Jurgen Kaiser and erlassjahr.de together with the Chapter 9 proposal of Raffer and Jubilee Research. There are the same for all practical purposes Kaiser (2001) to comments, "erlassjahr.de supports the proposal made by the Austrian economist Prof. Kunibert Raffer…..Raffer suggests an internationalisation of the Chapter 9 of the US insolvency code."

[17] Raffer (1990) uses the examples of Germany in 1953 and Indonesia in 1971 to show that ad hoc courts can be set up quickly and come to a satisfactory resolution.

[18] Raffer (1990) p303, under Chapter 9 law, a "special taxpayer" is someone whose tax burden will increase as part of the suggested plan; the individual, or individuals, in question have the right to be heard in court proceedings on the plan.

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