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The Search for a New Approach to Restructuring Sovereign Debt

−A Private Sector Perspective on the Krueger Proposal: an International Bankruptcy Mechanism−

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1. Private Sector Involvement

Private sector involvement (PSI), a complex but evolving issue, has been one of the focal points in the discussions aimed at strengthening the architecture of the international financial system for the prevention and resolution of financial crises. PSI was discussed extensively, and several tools were proposed at the G-7 Finance Ministers Meeting in Cologne in June 1999, followed up by the subsequent G-7 meetings in Okinawa (2000) and Geneva (2001). Although there have been some successful cases of PSI, particularly in bond restructuring—like Pakistan, Ukraine and Ecuador—at least at the initial stage, it has been said that proposals have not been implemented as rigorously as expected by the G-7. From the official sector's perspective, further steps are necessary to secure PSI, so that private creditors bear responsibility for the risks that they take.

The G-7 argument was a manifestation of the criticism that the injection of virtually limited public funds to crisis-ridden economies in fact bailed out private creditors. In the Latin American debt resolution of the 80s, bailouts were carefully avoided. Private

creditors—at least until the mid-80s—agreed to restructure sovereign debt, and also to provide their share of new money when there was a financial gap. Official funds were committed with contributions from private creditors, a practice called "bail-in." Crisis resolution in the 90s was led by large-scale public financing that was first provided to several crisis-ridden economies. A typical example was the Mexican crisis of 1994-5. The United States and the IMF injected a huge amount of public funds into Mexico, and as a result, private creditors could recover their investments. The crisis was averted immediately, and Mexico was soon able to restore access to the international capital markets.

Following the Mexican recovery, IMF and bilateral government financing was provided to resolve the subsequent East Asian crisis of 1997-8, involving Thailand, South Korea, and Indonesia, as well as Russia and Brazil (in 1998-9) as the crisis spread to other areas. As a result—except for Russia, which defaulted, and Indonesia, which is still in the process of restructuring its debts—the economies of these countries swiftly recovered, and some could restore access to the international capital markets.

Recently, however, the G-7 countries, particularly the United States after the Bush administration took office in January 2001, appear to be increasingly unwilling to provide large-scale official financing for crisis resolution. In the cases of Argentina and Turkey, IMF facilities have been provided piecemeal in recent years, and bilateral government financing has not been provided at all. The public sector's cautious attitude in providing official financing to crisis-ridden economies reflects a growing reluctance to bail out private creditors that may create a moral hazard. It appears that the IMF has been under pressure from the G-7 to come up with a new solution, towards active involvement of the private sector in resolving financial crises.

2. The Krueger Proposal

Some finance officials argue that the reason why PSI is considered difficult, and has not been implemented as expected by the G-7, is that no rule on PSI has been established. On November 26, 2001 Anne Krueger, the IMF's First Deputy Managing Director delivered a speech at a meeting of the National Economists' Club in Washington, proposing a new approach to sovereign debt restructuring. The proposal aimed to create a legal framework to help countries with unsustainable debts to resolve them promptly and in an orderly way, providing a new rule-based approach towards sovereign debt restructuring.

According to the proposal, a sovereign state which is in difficulty in servicing its debt with an unsustainable level of debt, will place itself at a temporary standstill, under a legal framework to be established in a manner similar to bankruptcy procedures for private firms

as, for example, US Chapter 11 of the Federal Bankruptcy Law, to protect the debtor government from private creditors (called an international bankruptcy mechanism). The government will first apply to the IMF for a standstill, and the IMF will sanction the proposal. The IMF is to set conditions that the government will conduct negotiations with private creditors in good faith, while also introducing corrective policy measures (possibly combined with foreign exchange controls) during the breathing space created by a standstill.

A unique point discussed in the Krueger proposal is the issue of litigation brought about by so-called rogue investors. Krueger, referring to the Elliott Associates vs. The Republic of Peru case[1], argues that in order to fight against rogue investors, a sovereign debtor needs to be legally protected from creditors under an international bankruptcy mechanism. Litigation is a disturbing element in the process of restructuring debt, but it should be noted that there have been reportedly only a few cases of it involving sovereign debt. The question is therefore, whether the fear of litigation would justify the introduction of a rigid legal mechanism to protect a sovereign debtor against private creditors.

In the background of the Krueger proposal, major changes took place in the international financial markets. First, entering into the 90s, international private capital flows to emerging market economies increased dramatically. Net international private flows to emerging market economies during 1998-2001 are estimated to have reached an average of US$140 billion annually, while net official capital flows during the same period are estimated to have reached an average of US$23 billion annually.[2]

Secondly, while cross-border bank loans were provided mostly in the form of short-term loans in the 90s—in contrast to the syndicated loans of the 80s—flows in the form of medium and long-term bonds and direct investments increased. As a result, private creditors have become increasingly numerous and diverse, making it difficult to reach a consensus among them. The flow of private capital has become an important financial resource necessary to economic growth in emerging market economies. At the same time, however, the rapid expansion of private capital flows has exposed emerging market economies to higher volatility.

As a response to the changing circumstances, some finance officials now believe it is necessary to establish a mechanism, such as a rule-based approach, to carry out debt restructuring in a quick and orderly manner, while also involving the private sector more effectively.

The rule-based approach would be a departure from the practice of the case-by-case approach which has been supported by private creditors. The G-7 has also expressed their support to a "voluntary, case-by-case approach" in dealing with the resolution of the debt

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1 IMF: Involving the Private Sector in the Resolution of Financial Crisis-Restructuring International Sovereign Bonds (2000)
2 Institute of International Finance

crisis. Yet the public and private sectors do not share same view when it comes to the question of burden-sharing in resolving a crisis. The G-7 Finance Ministers' report in Cologne (1999) clarifies the relationship between the official sector and private creditors. It states: "In a crisis, reducing net debt payments to the private sector can potentially contribute to meeting a country's immediate financing needs and reducing the amount of finance to be provided by the official sector."

Let us look at the characteristics of the traditional approach, focusing on a temporary standstill that played a critical role in determining the nature of debt restructuring.

3. Standstill

There have been several cases where governments defaulted, as in the recent Argentine case, but governments have usually avoided formal defaults by imposing, in effect, a "standstill" for a limited period of several months or so, during which the governments negotiated restructuring with private creditors, while also introducing corrective policy measures.

In the Latin American debt crisis that first erupted in Mexico in 1982 and spread to almost all Latin American countries, each crisis started with the announcement of a standstill by the government. Under standstill arrangements, private creditors reached a consensus to accept a standstill, on the condition that they reserve full legal rights stipulated under the loan agreements, including the right of litigation. Agents of syndicated loans played a critical role in reaching this consensus, communicating with all members in each syndicated loan. The reservation of full rights worked as bargaining power for private creditors in negotiating with a sovereign government. A temporary standstill, which was designed as a less confrontational arrangement, seeking the understanding of private creditors, was thus a useful tool adopted by a debtor government. By announcing a standstill, a debtor government lost access to the capital market, but could conduct orderly negotiations with a bank advisory committee established as a body to represent international private creditors.

The perception on the nature of sovereign debt has changed dramatically in the past two decades. In the days of the Latin American debt negotiations in the early 80s, it was believed that, except in cases of governments who are not willing to repay, sovereign debt would not default so long as the government undertook appropriate corrective policy measures assisted by the IMF. On the basis of this simple thought, bank creditors agreed to be bailed-in, i.e., to restructure debt and also provide new money.

Entering into the second half of the 80s, however, the situation changed. Sovereign debts began to be traded at a discount in the secondary market. Towards the end of the 80s,

the debts of many Latin American governments were partially written down, in accordance with the Brady Plan, and the decade-old Latin American debt problem came to an end. The Krueger proposal goes one more step forward, incorporating an unprecedented arrangement in which sovereign debt is treated like a private firm's debt under an international bankruptcy mechanism, even though sovereign debt is different in many respects from private debt.

4. Issues To Be Addressed

The private sector is and will continue to be the largest creditor group to emerging market economies. The Krueger proposal, if realized, will significantly affect PSI and the economies of emerging markets.

The immediate question is whether creation of an international bankruptcy mechanism is possible. In addition to amendments to the IMF Charter, it will be necessary to amend or enact bankruptcy laws in all IMF member countries. Since this task is close to impossible, Krueger further suggests an alternative route, such as a treaty obligation by amending the IMF Charter. This would require the support of three-fifths of the members holding 85 percent of the IMF's total voting power, whereby a majority decision would be binding on all members. Is there a strong political will on the side of G-7 to carry this out? If the opinion of the G-7 is divided, it will be difficult to establish this framework. Furthermore, even if the G-7 members reach a consensus, it is uncertain whether emerging market governments will support the proposal.

The second question is what kind of issues would arise with respect to the flows of private capital to emerging market economies and crisis resolution, in the event the proposed international bankruptcy mechanism is adopted:

- Private capital flows to emerging market economies will be adversely affected by the establishment of an international bankruptcy mechanism. When the economic situation of a debtor country deteriorates, the threat of a standstill under a new legal framework could precipitate the outflow of private capital, and the country's external balance may become destabilized.
- Since the decision on a standstill will be made between a debtor government and the IMF, private creditors will not be in a position to participate in the process. The process will therefore create unease among private creditors, which may eventually develop into a conflicting relationship between the public and private sectors. If standstills are implemented too easily, it will create a moral hazard on the side of debtor governments.
- The leakage of information on standstill negotiations between a debtor government

and the IMF can have serious consequences on a country's capital account and foreign exchange market, since it could trigger the outflow of private capital fearing the consequences of the new legal framework.

- IMF will influence the whole process, starting with the decision of whether the debt level is considered unsustainable, and whether a standstill should be adopted, while it supervises the process of corrective policies and debt negotiations with private creditors. Although the IMF will try not to influence, for instance, the outcome of negotiations, it may in effect significantly limit the sovereign power of the debtor government.
- If the proposed legal framework is introduced, the deeply interwoven legal systems and practices prevailing in the international financial system will have to be redefined. Many practical questions will arise: whether a trade line or a project finance, which has an underlying transaction, will be treated differently from straight sovereign debt, and whether the preferred creditor status enjoyed by international institutions as a matter of practice will be protected under the new mechanism. Many practical questions will need to be addressed to avoid creating serious problems in the international financial system.
- The Krueger proposal has been considered in the context of sovereign debt. Once a mechanism is in place, however, standstills can be applied to suspend payments on private sector external debt. It should be noted that, different from the Latin American debt crisis (which was mostly brought on by sovereign government debt), the East Asian crisis of 1997-8 was dominated by private sector debt.

5. Private Sector Perspective

The Krueger proposal will be met by negative reactions from private creditors in general. The reactions of G-7 members to the Krueger proposal are not known, but may be divided. The reaction of the emerging market governments may be a cautious one, because while some may consider orderly workouts desirable, others may believe that the creation of an international bankruptcy mechanism would have a negative impact upon their credit ratings and cause private capital flows to decrease.

It is my understanding that the objective of the Krueger proposal is to promote restructuring of unsustainable sovereign debt in a swift and orderly way by promoting PSI, and that the international bankruptcy mechanism is to serve this objective. Private creditors should seriously consider how they are to be involved concertedly in crisis resolution, while they cannot expect to be bailed out by the official sector. From the private sector perspective,

the following points should be taken into consideration with regard to the Krueger proposal.

i. Avoiding a confrontational relationship

Any mechanism—legal or otherwise—that would result in a confrontational relationship between a debtor government and private creditors should be avoided at all costs. Cross-border private capital flows provide important financial resources to many emerging market economies, and also business opportunities for private creditors. Maintenance of good investor relations is therefore indispensable to both parties. The Krueger proposal, which binds a debtor and its creditors rigidly under an international bankruptcy mechanism, may add an element of confrontation between the two parties.

ii. Importance of the financial contract

It is of utmost importance that both debtor governments and private creditors observe and strictly meet contractual obligations. Any outside forces that impose a change in a contract should be avoided at all costs. Through past experiences, private creditors should understand that risks are involved in doing business in emerging market economies, and that in extreme cases the introduction of a standstill is necessary. In that event, it is in the interest of both debtor governments and private creditors to undergo swift and orderly restructuring, in accordance with a provision included in the contract between a debtor government and its private creditors. Further study on such a provision will be needed.

iii. Collective action clauses

The inclusion of collective action clauses in a bond contract would help to adopt concerted action by bondholders, allowing more flexibility in modifying the terms of a bond contract. In view of the limited availability of official funds, and the growing share of bondholders in emerging-market financing, bondholders should no longer be immune from restructuring, but be treated as equal to bank creditors. This principle of equal treatment of private creditors will be in the interest of creditors in general. It is unfortunate that, collective action clauses first proposed by the G-7 in Cologne, have not been implemented because debtor governments and private creditors failed to reach a consensus on the issue. Efforts should be exerted to realize collective action clauses.

iv. Dealing with rogue investors

Krueger believes that an international bankruptcy mechanism is needed as a safeguard against rogue investors disturbing the restructuring process between a debtor government and private creditors. By including collective action clauses in the

bond contract, however, it would be possible for qualified majority bondholders to block litigation which may be brought by minority bondholders, and thus eliminate disturbing elements in negotiations on debt restructuring. Therefore, private creditors, particularly, bondholders, should understand the function of collective action clauses and support their inclusion in bond contracts.

6. Conclusion

There is undoubtedly a need to improve the international financial architecture. As Krueger points out, "There remains a gaping hole: we lack incentives to help countries with unsustainable debts resolve them promptly and in an orderly way." The central issue in debt resolution, as far as PSI is concerned, is the question of balancing bailout and bail-in, in other words, burden sharing between the public and private sectors. Private creditors are unlikely to support the international bankruptcy mechanism as proposed. If so, it is necessary for private creditors to consider how to achieve the shared objective of swift and orderly debt restructuring.

Member government positions will become clear as the IMF engages in discussions on the Krueger proposal with them. The IMF and the public sector should also engage in dialogue with private sector institutions, including not only representatives from banks, but also investment banks, institutional investors, fund managers, pension funds, and other parties. On the basis of "constructive engagement" between the public and private sectors, PSI should be constantly reviewed in light of the changing environment surrounding the international capital markets. Such dialogue among the concerned parties will help promote mutual cooperation that may lead to a non-confrontational, more realistic, long-term solution to the orderly restructuring of sovereign debt.

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