2003.2.1 (No.2, 2003)

Newsletter

Institute for International Monetary Affairs
(財) 国際通貨研究所

More Pubic-Private Dialogue Needed on the Sovereign Debt Restructuring Mechanism (SDRM) [1]

Tadahiro Asami
Managing Director
The Institute for International Monetary Affairs

1. Introduction

Some of the highly indebted emerging market economies such as Argentine, Brazil, Turkey and Indonesia are in an unstable economic condition. Argentine, which defaulted in December 2001, also failed to honour its debt to the World Bank in November 2002. A breakthrough in its negotiations with the IMF is not expected in the near future, and depending upon the outcome, it may constitute a potential threat to other emerging market economies. Although neighbouring countries are in no immediate danger of contagion, government bond spreads of highly indebted economies such as Brazil, tend to remain extraordinarily wide, weighing heavily on their debt service burden.

In April 2002, the International Monetary and Financial Committee (IMFC), endorsed the view of the IMF that the international financial system lacks a strong legal framework for the predictable and orderly restructuring of sovereign debt and encouraged it to investigate a two-track approach to solving the problem[2] The first is a statutory approach, namely the "Sovereign Debt Restructuring Mechanism" (SDRM) originally proposed by Anne Krueger of the IMF in November 2001, which has been studied in detail, taking into account the views of market participants and others affected by the mechanism. The second is to attach Collective Action Clauses (CACs) to individual bond issues so as to permit a qualified majority of holders to authorize a restructuring that would bind all holders of that issue.

The IMF will hold a series of discussions at its board and outreach meetings to prepare a

---

[1] This paper was published in "International Finance Journal No1099" issued by Institute for Foreign Exchange and Trade Research in February 1, 2003.

[2] Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, April 20.2002.

detailed SDRM proposal to be considered by the IMFC at its meeting scheduled for April 12, 2003. Although the position of each of the G7 countries on the SDRM is not yet known, it appears that they are ready to consider the proposed mechanism. While finance officials are working on the SDRM proposal, private creditors and market participants, who are deeply concerned with the issues associated with the proposal, have followed its development for the past year. Last December, six private business associations[3] issued a joint statement declaring their strong opposition to the SDRM, stating that "the SDRM is both unnecessary and counterproductive".

In view of the debates that should become increasingly lively towards this spring, this paper focuses on the SDRM from the private sector perspective. The paper first explains the outline and the background of the SDRM proposal and reviews some basic issues.

The paper then looks at the private sector perspective and the reasons for its objection to the SDRM. Then it makes the case for the application of Collective Action Clauses (CACs) as the market friendly mechanism for emerging markets and creditors, while at the same time referring to its shortcomings. On this basis, the paper argues that private sector participants should take the initiative to introduce CACs in bond contracts and should further clarify their position on the SDRM to promote deeper understanding between the public and private sectors on financial crisis.

2. Deepening Discussions on the SDRM

The SDRM proposes to treat a sovereign state with an unsustainable level of debt in a manner similar to bankruptcy procedures for private firms like Chapter 11 of the US Federal Bankruptcy Law. The initial Krueger proposal has been substantially modified, reflecting criticism from private market participants and others regarding, in particular, preserving creditors' rights and diminishing the power and role to be played by the IMF. However, the concept of "creating a bankruptcy judicial mechanism without a bankruptcy court" basically remains unchanged. The following is a brief explanation of the main aspects of the SDRM, as revealed by the staff paper made available recently[4].

(1) Objective

The objective of the SDRM is to catalyze the restructuring of unsustainable sovereign debts in an orderly, swift and predictable way, by creating an international statutory framework, thereby decreasing the economic and social costs to sovereign debtors and creditors. According to Anne

---

[3] Six associations are the Emerging Market Creditors Association, EMTA (formerly Emerging Markets Traders Association), the Institute of International Finance, the International Primary Market Association, the Securities Industry Association, and The Bond Market Association.

[4] International Monetary Fund, The Design of the Sovereign Debt Restructuring Mechanism-Further Considerations. Prepared by the Legal and Policy Department and Review Departments (in consultation with the International Capital Markets and Research Departments), November 27, 2002.

Krueger, "the principal feature of the SDRM is that it would allow a sovereign and a qualified majority of creditors to reach an agreement that would then be binding on all creditors subject to the restructuring." [5] The creditors will then be able to make decisions on an aggregate basis to eliminate creditors who hold-out, disrupting the restructuring process.

(2) Scope of Debts

The SDRM will identify the types of debt that could potentially be subject to restructuring while it would depend upon negotiations between the debtor and the creditors on whether all or only part of the debt would be restructured in a particular case. While the staff report says that the scope of claims to be included in the restructuring will likely be wide, it excludes claims that are governed by domestic law, claims that benefit from privileges such as secured claims, and claims held by international organizations. The question of whether restructuring of claims held by official bilateral creditors (Paris Club debts) will be included remains to be solved.

(3) Activation

The mechanism is to be activated on the initiative of the sovereign government whose debt has become unsustainable. (Initially, based on the IMF assessment that the debt is no longer sustainable, the sovereign debtor would apply to the SDRM and the IMF would give its approval). The debtor government would declare that its debt has become unsustainable. A critical question in this respect is whether it is necessary to provide for independent confirmation by a third party of the government's declaration of unsustainability and if so, which entity is to perform this function.

(4) Debtor Information and Restructuring Agreement

Upon activation, the debtor is required to provide all information regarding its indebtedness (including debt that will not be restructured under the SDRM) to its creditors. An expeditious registration and verification process would take place to enable creditors to be in a position to vote on an aggregate basis. When a sovereign debtor proposes a restructuring agreement, it would also be required to provide information as to how it intended to treat claims that were not to be restructured under the SDRM. This would enable holders of registered claims to make a decision regarding the sovereign's proposal with the full knowledge of how other claims would be treated.

(5) Creditor Rights

It was stated that, in order to protect creditors and their contractual rights, the activation of the

---

[5] International Monetary Fund. Sovereign Debt Restructuring: Messy or Messier? Annual Meeting of the American Economic Association, January 4, 2003. Washington, D.C.

SDRM should not automatically trigger any suspension of creditor rights.
In this context,an approach is being studied to discourage possible litigation which may occure,while ensuring inter-creditor equity.

(6) Creditors' Committee

As a means of encouraging active and early creditor participation in the restructuring process, a representative creditors' committee would be given a role under the SDRM to address both debtor-creditor and inter-creditor issues. The debtor would bear reasonable costs associated with the operation of this committee.

(7) Sovereign Debt Dispute Resolution Forum (SDDRF)

The SDDRF would be established in a manner that ensures independence, competence, diversity and impartiality. It would primarily carry out administrative functions including the administration of the voting process, dispute resolution during a restructuring process and injunction relief[6]

(8) Amendment of IMF Articles of Agreement

The SDRM and SDDRF will be established through an amendment to the articles of the IMF, which requires acceptance by 60% of its members and 85% of the total voting power. It is the responsibility of each member to determine whether the features of the SDRM would require changes in their own legal system.

Although the SDRM proposal is still under discussion, efforts have been made to introduce market-based considerations.

3. The Background of the SDRM Proposal

The background to the SDRM proposal was that private capital flows to emerging market economies increased dramatically from the beginning of the '90s, helped by the liberalization of capital flows. The main characteristics of private capital flows were, first, a dramatic decrease in medium and long-term loans in the form of bank-syndicated loans and an increase in short term loans. Second, a considerable growth in bond issuance in the international capital markets. Third, a large increase in foreign direct investment (FDI) which accounts for nearly half of private capital flows. Enhanced capital flows in the international capital markets resulted in the diversification of financial products, including bond issues and types of investors. As a result, it has become difficult

[6] Depending on the design of the SDRM, the SDDRF would be empowered to issue an order that would require a court outside the territory of the sovereign to stay a specific enforcement action if such an order was requested by the debtor and approved by creditors subject to the SDRM.

to coordinate numerous and anonymous private creditors.

The East Asian crisis of 1997-98 and its spread to Russia and Brazil was a clear indication that the international financial system was flawed. A wide range of reforms have been undertaken by the IMF, G7, G10, BIS and others in the international financial system. As a result of these efforts, some progress has been achieved in such areas as IMF surveillance, disclosure of information and transparency, and the strengthening of economic policies and the financial systems of emerging market economies. On the other hand, however, progress has hardly been made in private sector involvement (PSI) for the resolution of debt crisis that calls for burden sharing by the private creditors as a prerequisite of public support. The issue for the public sector was how to bail-in private creditors, when large-scale financial assistance is used for crisis resolution.

At the G7 Finance Ministers and Central Bank Governors Meeting in Cologne in June 1999, a proposal was made to include CACs for bonds issued by emerging market economies in international capital markets in order to avoid bailouts of private creditors and to increase their participation. In view of increasing bond issues by the emerging market economies in international capital markets, it was deemed necessary to introduce CACs, which enable bond restructuring, as a way to enhance private sector involvement (PSI).

In the case of the Latin American sovereign debt crisis of the '80s, sovereign debt in the form of bonds constituted only a fraction compared to bank loans, and was excluded from restructuring and duly redeemed. This unequal treatment resulted in the notion among some investors and underwriters that bonds were safer instruments than loans. Because of this background, the proposal for CACs by the G7 met with a mixed response from banks, underwriters and investors. Despite subsequent efforts by the G10 to develop public-private sector dialogue on the implementation of CACs, private sector consensus was not reached. A strong sense of frustration must have been felt within the G7 and the IMF, when no tangible progress was made on PSI, while private sector flows into emerging market economies were growing in importance. Finance officials must have concluded that in order to enhance restructuring of claims held by private creditors, a legal framework such as the SDRM needed to be established.

4. Collective Action Clauses (CACs)

While the SDRM places sovereign debt restructuring under a statutory framework, CACs are a market-based approach which permits a qualified majority of bond- holders to agree to a restructuring on the basis of contracts between a debtor government and its creditors. According to the G10 report, CACs can be included in sovereign bonds that are issued under the jurisdiction of British, French and New York laws in which an overwhelming amount of sovereign bonds have been issued.

If bond issues cannot be restructured when necessary due to the lack of CACs, such a market arrangement should be considered defective. Based on such recognition, market participants should take the lead in drafting model clauses of CACs and seize the initiative to introduce such model clauses for bond issues in international capital markets. Many of the emerging market economies are concerned that the introduction of CACs in bond issues will result in an increase in their issuing cost. Since cost is a very important issue, a means to ease such a negative factor should be carefully studied. Including CACs in developed country government bonds should be seen not just as setting an example but as a means to correct market deficiencies.

However, there are two technically difficult aspects concerning CACs. The first is how to aggregate creditor claims across instruments. Changes in the terms of payment would be determined through voting by investors, on a contract by contract basis. A single sovereign debtor usually owes multiple debts through various issues and loan agreements. In addition, since contracts differ from case to case, creditors are divided into several classes. Therefore, the question of how to aggregate the different types of investors in separate contracts is technically a difficult problem. This hurdle has to be overcome in order to carry out efficient restructuring.

The second difficulty is how to deal with outstanding bonds that do not include the CACs. JP Morgan Chase has proposed a two-step approach for such stock of debt issues. According to this scheme, the first step would be to swap the old bond contracts without CACs into new contracts with CACs and the second step would then be to alter the contracts, such as in payment terms. This proposal should be developed further to find a solution to this difficult problem.

5. The Reasons for the Private Sector’s Objections to the SDRM

Many of the concerns associated with the SDRM which were indicated by the six business associations have been taken into consideration and reflected, to some extent, in the IMF’s staff paper. However, there are still many loose ends. Since the final IMF proposal has not yet been announced, the basic concerns of the private sector related to the principles of the SDRM summarized below represent critical points for the private investors. Therefore their outcome should be watched carefully.

(1) Importance of Contract

It is important, as a matter of principle, to observe the original contract between a sovereign state and its creditors to the maximum extent possible. This principle should be maintained under the SDRM, and it is a positive development that the report mentions that the creditors’ rights should not be automatically suspended after the triggering of the SDRM.

(2) Inter-Creditor Equity

The definition of the affected debt for the purpose of restructuring should be as broad as possible to create a framework where creditors share the burden fairly. However, it is likely that affected debts will be limited to sovereign debts contracted under a foreign jurisdiction and held by private sector investors. This signifies the de facto subordination of sovereign debts owed by the private sector to other sovereign debts, which will create a restraint on the flows of private funds and result in a significant increase in the cost of debtor countries. There have been many cases recently where non-residents have bought domestically issued foreign currency-denominated bonds and where domestic investors have bought bonds issued abroad. Therefore, the question of whether debt to be covered under the SDRM would be determined in accordance with jurisdiction needs to be addressed. The Mexican crisis of 1994 was a liquidity crisis involving Tesobonos, which were a foreign-currency denominated domestic bonds. The Russian crisis of 1998 was also related to domestic bond issues. So even if the SDRM had been in existence then, the mechanism would not have been applicable to such bonds. It has not been determined whether Paris Club debt will be restructured outside or under the SDRM, but it is an important issue that needs careful consideration from the point of view of inter-creditor equity.

(3) Collective Action Problems

The collective action problems of free riders and litigation by creditors, which are considered to be one of the reasons to support the introduction of the SDRM, have been exaggerated. The restructuring of Ecuador, Ukraine and Pakistan bonds were successfully concluded in recent years with over ninety seven percent of creditor participation and were not blocked by the creditors' legal actions.

(4) Judgement of Debt Unsustainability

The staff report states that the debtor government should determine the activation of the SDRM based on its judgement that its debt is unsustainable. The IMF would play a very important role in the decision by a sovereign debtor to activate the SDRM. Such a decision would depend on many factors such as the size of the IMF facility, the political will of the debtor government to implement policies, the economic environment surrounding the country and PSI. The procedures, in particular, judging that a country's debt is unsustainable should be more clearly stipulated in order to make the process more transparent. For this purpose, the idea of introducing confirmation by a third party on the country's judgement that its debt is unsustainable, should be implemented.

(5) Conflict of Interest

When the SDRM is activated by a debtor government, the IMF is in a position to know the debt profile of the country, since the IMF determines the economic package and financial support for that country. With the activation of the SDRM, the IMF will be in a position to recover its loan to that country as it enjoys preferred creditor status. Therefore, the role of the IMF, both formal and informal, needs further scrutiny.

(6) SDRM and CACs

The IMF and G7 support a two-track approach, because the SDRM and CACs are thought to be complementary. However, private sector participants consider that the introduction of the SDRM would override CACs, and therefore, they are not complementary. On this issue, the private sector's opinion appears to be correct. CACs can be implemented relatively swiftly, since CACs have been recognized as a viable method by the official and private sectors, while the SDRM needs more comprehensive and detailed consideration.

6. Progress Made in Public-Private Dialogue

The SDRM proposal by the IMF serves as a warning to private creditors who did not respond positively to its proposal for private sector involvement (PSI), which is a prerequisite for the resolution of financial crises. While the private sector has clearly indicated its opposition to the SDRM, it has given its support to CACs, reversing their earlier negative attitude. Concerning the injection of public funds for crisis resolution, the private sector has also acknowledged its responsibility for self-chosen risks and the advisability of avoiding bailouts of private creditors by large-scale financial assistance. The private sector is studying ways to hold a systematic dialogue between a debtor government and its private creditors to create a kind of early warning system. It is also endeavoring to establish a code of conduct for all the parties involved in the emerging market debt issues. Similar studies have been undertaken by finance officials, and therefore, the public and private sectors are working in parallel towards the same goals.

In the latest IMF staff report, the concerns of market participants have been reflected to the extent that many Directors of the IMF stated that "efforts to achieve broad support from market participants are welcomed, but should not dilute the mechanism to a point that it would loose its effectiveness." Since the SDRM proposal has not been finalized, it is premature to form a positive or negative opinion at this point in time. The private sector should look at the SDRM proposal closely in order to formulate its opinion on important issues like scope of debt, activation procedures, the relationship between a debtor and its creditors and the role of the SDDRF, which require active consultation with market participants.

Address: 3-2, Nihonbashi Hongokucho 1-chome, Chuo-ku, Tokyo 103-0021, Japan

Telephone: 81-3-3245-6934, Facsimile: 81-3-3231-5422
〒103-0021　東京都中央区日本橋本石町 1-3-2
電話：03-3235-6934（代）ファックス：03-3231-5422
e-mail: admin@iima.or.jp
URL: http://www.iima.or.jp