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# Revisiting the IMF's Sovereign Bankruptcy Proposal and the Quest for More Orderly Sovereign Work-Outs

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## **Background**

On November 26, 2001, the IMF's First Deputy Managing Director Anne Krueger proposed that sovereign financial crises be subject to a sovereign bankruptcy regime. The proposal was re-articulated by Ms. Krueger in her dinner remarks [at this conference] on April 1, 2002. Presumably, the proposal has support among some G-7 policymakers, as they search for mechanisms to make sovereign work-outs more orderly, but others will want to hear more from the private sector before they take a final position on the proposal.

While the IMF proposal was conceptual only, it contemplates that a debtor country could request that the IMF grant a temporary standstill on its debt repayments, during which time it could negotiate a restructuring acceptable to a super-majority (e.g., 2/3's) of creditors, whose assent would bind the minority creditors. While the regime is meant to be analogous to domestic bankruptcy, many important features would need to be defined.

In his luncheon remarks earlier today [at this conference], John Taylor, U.S. Deputy Secretary of Treasury for International Affairs, expressed the U.S. view that a preferable approach would be for sovereign borrowers and their creditors to include a package of new clauses in their debt contracts, including majority action clauses, as well as clauses describing procedures to be followed in the event a restructuring became necessary.

<sup>\*</sup> These remarks are personal views only and do not necessarily reflect the official views of EMTA or any of its member firms.

We have heard many ideas recently relating to the quest for more orderly sovereign debt reschedulings, some better than others. Among the better ones is J.P. Morgan's proposed two-step approach, articulated today by Ed Bartholomew, that contemplates a preliminary exchange of existing debt for new instruments possibly with majority action and other restructuring-specific clauses. This proposal dovetails nicely with Mr. Taylor's call for decentralized inclusion of such clauses in debt contracts and might address some of its problems.

Most importantly, the J.P. Morgan proposal demonstrates a key point of my remarks — the type of pragmatic creativity that can be brought to bear by the private sector on a case-by-case basis to address specific problems that can arise in the context of sovereign debt restructurings. This creativity should not be underestimated.

With all due respect, last night at dinner, I was reminded of an experience that I had years ago in college when I wrote a philosophy paper that was badly received. Thinking it the appropriate thing to do, I rewrote the paper and resubmitted it to my instructor. Several days later, he gave it back to me, but with an even lower grade. On it, my instructor had written something like "The more clearly you express your arguments, the more apparent are their weaknesses."

## The Problems with Sovereign Bankruptcy

In that spirit, I used to think that the IMF's sovereign bankruptcy proposal had two fundamental flaws, but today I think there are at least three basic problems.

- (1) <u>First</u>, the proposal is based on the assumption that the existing mechanisms for resolving sovereign financial crises do not work (or do not work well enough) because sovereign debt restructurings are too prone to disruption by hold-out (or so-called "rogue") bondholders. Thus far, this assumption is contradicted by our experience.
  - (a) The current mechanisms, which are flexible enough to be applied on a case-by-case basis, involve a spectrum of approaches (ranging from formal negotiation with a creditors committee to formal or informal consultation) and legal structures (ranging from formal amendment of existing debt contracts to exchange offers). These mechanisms are not necessarily popular with debtor countries or all of their creditors, and they each have their advantages and disadvantages. as well own characteristics that make them work better in some contexts than in others. They certainly do not lend themselves to 'neat solutions'. in part because most bond contracts (at least those governed by NY law) provide that their payment terms cannot be amended

without the consent of "each bond affected thereby". However, these mechanisms should not be measured against the standard of 'neatness', but rather against the better standard of their practical effectiveness. For their faults, they have worked better to resolve financial crises and return debtor countries to the markets than would the IMF's sovereign bankruptcy proposal.

- (b) The so-called 'collective action' problem (ie., that sovereign bond restructurings will be unduly held up unless new mechanisms are developed to permit a super-majority of creditors to bind the remaining minority) is more theoretical than real. Since the problem was first identified, debtor countries such as Russia, Ecuador, Pakistan and the Ukraine have been able to restructure all, or a substantial portion, of their external bonds in reasonable time-frames through the use of exchange offers (which in some cases were accompanied by various exit consents to encourage full participation). Experience has shown that so-called "rogue" creditors have not obstructed these or other sovereign restructurings. Even in the most widely cited (and possibly only) example of 'rogue-ish' behavior, a single creditor's actions appeared to threaten, but in fact did not disrupt, Peru's 1997 restructuring under the Brady plan and only collected payment three years later. Accordingly, the danger of hold-out or 'rogue' creditors has been highly exaggerated.
- (2) The <u>second</u> fundamental flaw in the IMF sovereign bankruptcy proposal is that it would severely compromise the legitimate right of creditors to enforce their claims and thereby upset the delicate balance that now exists between the rights of sovereign debtors and their creditors. Rather than making the process of sovereign work-outs more orderly, the main effect of the proposal would be to further reduce the flow of private capital to the Emerging Markets.

One of the principal objectives of a sound bankruptcy regime is to provide stability and predictability in the credit markets by striking an appropriate balance between the rights of debtors in financial crisis and their creditors. In a corporate context, this balancing results in efforts to maximize the value of a debtor's assets. If the debtor's business is not viable, it may be liquidated, with its assets in effect being applied to repay its debts. If its business is viable, there are mechanisms to reorganize it that operate to maximize the prospects of eventual repayment.

In a sovereign context, of course, liquidation is not an option. Unfortunately, neither are a number of the most important mechanisms that normally ensure that the rights of creditors are adequately protected, mechanisms such as the ability to restructure the debtor's business, sell

its non-strategic assets, change its 'management', and comprehensively treat all of its creditors. Even if these standard creditor protections were elements of the sovereign bankruptcy proposal, how would they be enforced against sovereigns?

Bankruptcy regimes work as a package of measures perceived as fairly balancing debtor and creditor rights and incentives. When such key elements are missing, the appropriate balance of debtor's and creditor's rights is upset, and credit will stop flowing as a result.

The legitimacy of a bankruptcy regime also depends upon there being an impartial arbiter whose judgments of fairness and efficacy strongly influence the reorganization process. As well-intended as the IMF may be, its status as a creditor owned and controlled by debtors and other official creditors would inevitably create a perception of bias that would damage the regime's legitimacy. The resulting perception of unfairness seems particularly untenable in a context where the IMF would be unlikely to be in a position, or to have the power, to enforce normal creditor protections.

(3) The third flaw is that the proposed solution, a bankruptcy procedure, does not really address the real problem, which is the failure of sovereigns to develop the institutions and systems, and to pursue the policies, that could provide greater protection over the long-term from severe economic and financial difficulties. Or, put another way, the bankruptcy solution only begins to operate after the 'cows have left the barn.'

An ounce of prevention is worth a pound of cure, and a crisis prevented is one that never needs to be resolved. A sovereign bankruptcy regime would not have helped to address the problems that led to Argentina's crisis. Other policy measure and incentives applied much earlier might have. The "gaping hole" in the current financial architecture is the apparent lack of effective policy measures and incentives to prevent sovereign financial crises, not the lack of mechanisms to ensure orderly debt work-outs.

For these reasons, the IMF proposal seems a serious step in the wrong direction.

### **Some Practical Considerations**

In my view, a more practical and effective approach toward resolving sovereign financial crises in the Emerging Markets should recognize the following considerations:

- (1) The term 'bail-out' is unduly pejorative and may obscure clear thinking about how best to avoid or resolve specific crises. In a number of notable cases, financial support packages have successfully enabled debtor countries to regain financial health and maintain political stability in times of severe financial crisis without any waste of taxpayer moneys. Moral hazard should not be exalted to the point where eliminating it becomes the paramount policy objective.
- (2) Similarly, the 'burden-sharing' debate has coincided with an extended period of sharply reduced private capital flows to the Emerging Markets and should be rethought. Locked into this debate, the main dialogue between the official and private sectors has revolved around how to restructure bonds more easily, a naturally divisive, contentious and ultimately counter-productive topic that tends to discourage stable private sector involvement at a time when it has shrunk and needs to be encouraged. While bondholders were once welcomed to the Emerging Markets as a source of stable capital, the burden-sharing debate tends to paint them all as speculators and potential roques and may even push them in that direction. Unfortunately, the time that many have spent thinking and talking about how to restructure bonds more easily has distracted both policy-makers, academics and private sector representatives from the larger picture of how best to meet the long-term financing needs of developing economies.
- (3) I was amazed to hear last night that the procedures for restructuring sovereign debt in the 1980's were orderly! While aspects of the process may have become familiar enough by 1990 or so to seem orderly, the early restructurings for the major countries were almost completely <u>ad hoc</u>, requiring the identification and consolidation of literally 1000's of individual debt claims by 100's of creditors with often wildly disparate views. Some restructurings took <u>years</u> to complete, and they were accomplished largely without the benefit of sharing clauses and majority action clauses only after a remarkable case-by-case effort in the face of a widely perceived risk of global financial meltdown. More recent mechanisms (notably, exchange offers) are, in fact, much more efficient at getting the restructuring job done.

As intellectually unsatisfying as it may seem, the case-by-case approach to resolving crises has evolved to work remarkably well, particularly when the approaches have been market-oriented. Neatness may not be as effective as the case-by-case approach in getting debtor countries back to the markets. Does the case-by-case approach need to evolve to better accommodate the realities of today's marketplace? Undoubtedly. It is far better for the market to develop new mechanisms itself than to have them imposed.

- (4) Contracts, even sovereign debts, should be enforceable. There is a growing perception in the bondholder community that they are not, and that creditor rights should be strengthened, not weakened. At a bare minimum, rather than overriding the rights of individual bondholders, greater attention should be given to seeking ways to ensure that bondholders are constructively included in the restructuring process.
- (5) I don't think that collective action clauses are particularly necessary or, at least in the short to medium-term, feasible to implement. If they are worth discussing, however, they certainly shouldn't be constructed in a way that is disproportionate to the size of the problem they are intended to resolve. If the perceived size of the potential hold-out problem in any specific debtor country is 2-3%, there does not seem to be any justification for collective action clauses that operate with any percentage less than 90-95%. Clauses with lesser percentages would, in effect, seriously intrude on the legitimate rights of creditors not to be bound to changes in debt payment terms made against their will.

#### A Final Word about Legal Rights

Legal rights are normally a last resort, a last defense against the erosion of capability or willingness to pay or perform. In a sovereign context, it is not that legal rights are less important, but that they have less practical value.

The inherent nature of sovereigns places some practical limitations on the rights that can be exercised against them. These limitations are in part codified by the Foreign Sovereign Immunities Act. Others derive from the reality that, within their borders, sovereigns are, almost literally, a law unto themselves. Enforcement against a sovereign within its territory of payment obligations, and perhaps more importantly, of the types of covenants that, in a corporate context, safeguard creditworthiness, is understandably difficult.

In a corporate context, covenants can be designed, such as restrictions on certain types of transactions, that can be enforced and provide protections against the erosion of creditworthiness. In a sovereign context, the construction of meaningful covenants is more problematic, and enforcement within the sovereign's jurisdiction is virtually impossible.

Because legal rights have less practical value, other mechanisms are needed to protect against the erosion of a sovereign's capability or willingness to pay. The normal discipline of the market, that such erosion will make market access more costly (or eventually cut it off), provides strong incentives, but those incentives also have practical limitations in the case of sovereigns, whose policies will ultimately be more responsive to the needs or desires of their electorates than to the interests of foreign investors.

So what is really lacking from the international financial architecture are mechanisms (such as infrastructure building) that supplement market incentives, long-term protective and preventive mechanisms that cannot be imposed but could be developed as a part of a country's overall long-term development plan.

From an investor's (and policy-maker's) standpoint, crisis resolution should be important, but less important than mechanisms that prevent crises from occurring. By the time a crisis has occurred, substantial investment value and capital has already been lost which may never be recovered. Developing stronger preventive mechanisms would be more valuable to the financial architecture than a sovereign bankruptcy code and would be a worthier challenge for policymakers to undertake.

#### Addendum:

Some Preliminary Thoughts on the Taylor Proposal – 4/2/02

The Taylor proposal for the decentralized inclusion of majority action and other restructuring-specific clauses has merit (inasmuch as it is much more market-oriented, as well as much less threatening to creditor rights, than the IMF's sovereign bankruptcy proposal), but it still has several obvious practical problems.

Like the IMF proposal, the Taylor proposal assumes a problem that is debatable (<u>i.e.</u> that current sovereign restructuring mechanisms are inadequate, largely due to the spectre of hold-out creditors, and it also under-estimates the ability of the private sector to fashion creative case-by-case solutions.

Perhaps most seriously, the Taylor proposal, by contemplating the construction and inclusion of majority action and other restructuring-specific clauses well before the circumstances surrounding any financial crisis are known, seems to run a real risk of resulting in either a 'one-size-fits-all' approach for all debtor countries, or an overly rigid approach for a country that cannot be expected to take into consideration the relevant circumstances of any specific future context in which the clauses would be used. The resulting loss of flexibility (which is presumably intended to provide greater predictability) may deprive the international financial community of one of the most significant advantages of

the current case-by-case approach – the ability to fashion responses to meet the circumstances of a specific debtor country's financial crisis.

That is, unless the Taylor proposal is implemented, not well in advance of financial crises, but rather in specific contemplation of one, when the circumstances of the debtor country's situation and debt profile can be taken into consideration. Inclusion of majority action and other restructuring-specific clauses could, for example, be developed for inclusion in the interim instruments contemplated by the J.P. Morgan proposal, rather than in each individual bond or other debt contract as it is issued. Introducing such clauses after the circumstances of the financial crisis were known would arguably reduce some of the certainty sought by the official sector but without sacrificing the obvious benefits of the flexibility afforded by the case-by-case approach.

Combining the Taylor and J.P. Morgan proposals might also address another problem conceded in the Taylor proposal, the difficulty of implementing clauses so that they could be applied across the aggregate of the debtor country's indebtedness.

Alternatively, the Taylor proposal could be implemented well in advance of any future financial crisis through an exchange offer in which existing debt is exchanged for new instruments that contain the Taylor proposal clauses. While this approach would also help address the problem of ensuring that such clauses would apply across the aggregate of a debtor country's indebtedness, it would still run the risk of sacrificing some of the flexibility of the case-by-case approach.