## FELSBERG *e* ASSOCIADOS

FELSBERG, PEDRETTI, MANNRICH E AIDAR ADVOGADOS E CONSULTORES LEGAIS

March 28, 2003

## **New Approaches to Sovereign Debt**

By Thomas B. Felsberg\*

In the last two years, the international financial community has been engaged in a more vigorous conversation about the perils of sovereign insolvency, and with good reason. We have witnessed crises of national economies and state financial failures, which have caused us to reexamine how the world lends money for development to the countries most in need of capital. As others have noted, we need to revisit the architecture of the credit systems in place. We need to consider our options for reform from the very point of credit decision, analysis and support through repayment, or restructuring.

The current architecture, although responsible for many successes, including the modern reform of state economies and infrastructures, has created situations in its failures that undermine the political support for a healthy, long-term supply of development capital to countries, projects and peoples in need. As we know, when a state fails fiscally, financial rescue by sovereign neighbors or by the IMF has the appearance, and the effect of a bail-out of private creditors. For financial institutions that have priced the country risk into the credits at risk, with commensurately high interest rates, the reward is a later repayment or guarantee by a first-rate sovereign debtor. The purpose, of course, is to enable the debtor nation to enter the lending markets again to provide liquidity, and avoid further disruption to its economy. But as we have seen, although the effect may be to encourage credit, it is felt by some that this result is at the expense of undisciplined lending and borrowing.

To simplify matters, I believe that strong sovereign development-credit systems need three reliable pillars: (1) rigorous financial analysis and credit determinations by the originating creditor; (2) fiscal planning and discipline on the part of the sovereign debtor; and (3) an organized work-out program and process for failed loans.

With respect to the third pillar, I am pleased to note that persuasive discussions and scholarship are being brought forward on the difficult subject of sovereign insolvency workouts. To date, however, no effective workout regime exists between private creditors and sovereign debtors, which in the end reinforces the incentive for creditors not to deal when default occurs. In the past, it has been the hold-out creditor that has been rewarded. In the parallel world of domestic bankruptcy, the existence of a structural framework alone encourages parties to come to the table and negotiate.

It should be noted, however, that reform to only this part of the system, may in fact limit development credit overall. After all, the credits may then be subject to a work-out process that provides for less than full recovery. For the creditor today, the "all or nothing" crisis situation resulting from non-payment, without recourse to work-out procedures, almost assures preservation of the obligation (unlike the pricing suggests). With the introduction of a work-out program, although critical to a long-term, viable sovereign market, the economics change materially for the lender. It is even possible that the cost of credit would rise as fewer creditors remain in the market, which once included a presumptive guarantee.

The exclusion of a developed world bail out – which in the "all or nothing" scenario was presumed – requires reform to all of the structures in the system to create and maintain a market attractive to lenders and borrowers, and ultimately encouraging development in countries in need. This reform inevitably requires a system that can foster competition, create standards, structurally quantify and allocate risk, offer means to mitigate risk and hold parties accountable – in other words, a mature financial market. A work-out structure is important in a mature financial market, but without complementary reform in other parts of the system, the ultimate effect may be to contract the markets, and limit the options to borrowers at even greater cost.

With respect to the first two pillars, additional attention needs to be brought to the current practices, and the system of risks and rewards currently in place. In an effort to bring heightened fiscal management on the parts of creditors and debtors, *prior to any potential failure*, I propose diversifying the credit options available to the market, by bringing tested public finance programs to

<sup>\*</sup> Thomas Benes Felsberg is the Managing Partner of the law firm Felsberg e Associados, São Paulo, Brazil. © 2003. All rights reserved. Contact Information: Av. Paulista, 1294, 2<sup>nd</sup> Floor, São Paulo, SP 01310-915, Brazil; Tel. (55)(11) 3141-9100; Email: <a href="mailto:thomasfelsberg@felsberg.com.br">thomasfelsberg@felsberg.com.br</a>; Web: www.felsberg.com.br.

the global sovereign market. A model which has proven effective for a high volume, efficient and liquid finance market for municipalities in the United States, is the "monoline" credit insurance system (referred to hereafter as, the "Monoline System").

The Monoline System has worked in the United States to create ready lines of capital to municipal borrowers who meet the fiscal standards set by a small group of credit insurers – all of which maintain AAA ratings through a clear program of fiscal discipline. The participation of the municipalities creates lower-cost credit and opens up credit from investors seeking borrowers adhering to stringent fiscal principles and meeting benchmark requirements. These debtors are subject to constant monitoring by the insurers which have a financial stake in the full performance of the debtors. The insurer provides a standard term insurance policy for repayment. The result is that a smaller borrower has access to the credit and pricing of a much larger institution.

This approach may appear to be a variation on a theme already in place. Multilateral organizations have already been effective in creating reform incentives and monitoring progress of debtor nations. Nonetheless, the current approach has not been fool-proof; it is by proposing additional layers of protections or incentives, or checks and balances, that the opportunity for failure may be diminished. Rarely does one simple approach fit all debtors.

Of course, the international markets differ in many ways from the domestic public finance markets; however, I believe that some fundamental principles of the Monoline System could be applied to create a more efficient, transparent, fluid and cost-effective sovereign finance market. Also, the benefit of existing institutions currently conducting complementary roles already in this market could be deployed to further enhance a relevant credit insurance scheme.

At a minimum, I would recommend the study by the multilateral finance institutions, such as the International monetary Fund and the World Bank, as to the feasibility of such a credit support program. A review should be conducted to consider establishing or promoting a monolines market for sovereign debt. The international monoline insurers would sell insurance based on the analysis of sovereign creditworthiness, principally for project finance structures, involving security or cash flow from project operations. International insurers are better able to reduce risk based on a precise project analysis and their access to a re-insurance market.

Further, project financing should be able to attract more lending competition, as well as reduced borrowing costs for the sovereign, if recognized multilateral insurance programs were able to support projects in a more standardized manner. The leading multilateral organizations, such as IDB, World Bank and MIGA, as well as some national agencies such OPIC, Eximbank, DEG, KfW, and the like, have extensive experience in the area of project finance, which demonstrates a practice of investing in projects and infrastructure that can pay for themselves, through amounts generated by the projects. Applying and leveraging this expertise, market know-how and discipline of programs such as these to credit insurance programs would create financial services that could create a larger lending pool – not just limited to the funds of these institutions.

By creating a broad-based market, with established norms and costs, and leveraging multilateral expertise and resources to quantify, allocate and mitigate risk through credit insurance, the efficiency would create a virtuous circle for all involved – lower costs for the borrower, safer investment choices for the lenders, and bail-outs not by the tax-payers, but by managed work-outs and funds from premium-financed insurance coverage.