RECENT THINKING ON HOW THE INTERNATIONAL COMMUNITY SHOULD FIX SOVEREIGN LIQUIDITY AND SOLVENCY CRISES

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Among the damages that followed in the wake of the global financial and economic crisis that erupted over five years ago was a sequence of sovereign debt crises. In light of widespread dissatisfaction at how the workouts from those debt crises have been handled, there has been a spate of new thinking on how to address sovereign debt difficulties. Some of this thinking seems addressed to countries facing illiquidity crises and some to countries that have become insolvent. This note discusses them in turn and then addresses more general questions of where debt workouts should be placed in the international governance structure.[2]

<u>Illiquidity</u>

The general expectation of governments is that when temporary additional borrowing needs arise, they can obtain credit from usual sources, such as banks or by floating additional treasury notes or government bonds. It is also generally expected that without additional net borrowing needs, the government will be able to roll over maturing credits into new borrowings. The government has a liquidity problem when the usual sources say "No" to new loans or want to charge unusually high interest rates or impose unusually short maturities (or both). That is to say, the government has lost normal access to credit, albeit for what are anticipated to be temporary reasons. A liquidity problem (as distinct from an insolvency crisis) implies that observers believe the liquidity shortage is temporary. Nevertheless, owing to the uncertainty, creditors see a risk that they won't be repaid. That fear may or may not be warranted. Investors can be fickle and they move in herds; they may love taking risk in lending to a government at one moment and abhor it the next. A major focus of fiscal management in most countries is acting so as to keep the confidence of the buyers of the government's securities, since loss of that confidence for whatever reason can be very costly.

A liquidity crisis is like a fever. The International Monetary Fund (IMF) may be said to be the doctor that comes to see the patient, gives a corrective prescription to regain health, and assuages the fears of hovering creditors. The Fund typically lends its own funds in this situation and it is hoped this act of IMF confidence calms the creditors. The government will use the Fund loans, inter alia, to pay off maturing credits, which thereby substitutes a country's maturing obligations to the private creditor with

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[2] As this note is meant to complement a paper by Brett House on his proposal with Richard Gitlin, it is not mentioned here despite being a very interesting initiative.

obligations of the country to the public sector (IMF). With such an IMF program in place, private creditors may become more confident and resume lending.

In sum, the usual response to a liquidity problem is to obtain official loans, possibly complemented by new private credit. One result is a higher debt level (and if GDP is falling, a significant jump in the debt/GDP ratio). If debt has been at a tolerable level, the added debt should not be deemed a problem. If the ex ante debt level was high, one can see a basis for private creditor reluctance to meet the government's expanded liquidity needs.

A different approach has been applied by government creditors in response to special cases of extreme difficulty. That is, the creditor governments that meet as the Paris Club granted a three-year deferral of all debt servicing due by Honduras and Nicaragua following Hurricane Mitch in 1998. The creditors also offered postponement of debt servicing to countries affected by the Indian Ocean tsunami of 2004. Indonesia and Sri Lanka took the offer of a one-year deferral while others did not. In both cases, in effect, creditors offered to refinance the debt servicing falling due during a period of shock and recovery. More recently, the Paris Club creditors offered this type of relief for other reasons; in particular, they offered Liberia a three-year hiatus in debt servicing in 2008 in recognition of its efforts to overcome its long-running internal political conflicts, and they offered a three-year deferral to Togo in the same year in response to "rocketing" food and fuel prices.[3]

The argument for the relief for these countries was that they should give higher priority to recovery expenditures (whether related to storms, peace building or international price shocks) rather than use scarce fiscal resources to pay principal and interest to their official bilateral creditors. Many creditor countries were offering other official support to these countries either in kind or grants and/or loans. Debt relief was thus deemed a part of a larger cooperation package. The debt relief portion of the package implied creditors wanted the affected governments to spend their own money in addressing their emergencies and the creditors were willing to wait to be repaid. Implicitly, the Paris Club members put themselves at the bottom of seniority in claims on the debtor government, but only in these extreme contexts.

The emergency relief policy of the Paris Club seems to be a good model for all creditors to follow for addressing liquidity difficulties, especially as regards assistance in emergency situations. Indeed, an advisory group to four international Protestant Church networks is just now making essentially this proposal in its report to the Church organizations, adding that the temporary relief should be comprehensive and automatically triggered.[4]

The thinking behind that proposal can be traced back to a proposal some years ago by a number of civil society organizations, including CAFOD (Catholic Agency for Overseas Development) in the United Kingdom, that the amount of money for debt servicing by poor countries should be calculated as what

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[3] Source: www.clubdeParis.org, accessed January 18, 2014

[4] World Council of Churches, World Communion of Reform Churches, Society for World Mission and Lutheran World Federation, "An Economy of Life for All Now: An Ecumenical Action Plan for a New International Financial and Economic Architecture," Report of an Advisory Group, forthcoming.

would result after essential government social (and administrative) expenditures were deducted from reasonable estimates of tax revenues.[5] This proposal can be thought of as aimed at ensuring no disruption took place in programs to realize the Millennium Development Goals to which the donor governments had committed themselves. It also could be seen as reflecting obligations that governments were meant to undertake as international human rights duty bearers to act so as to prevent "retrogression" in social and economic progress.[6]

Staff of the IMF more or less came to a similar conclusion last spring, albeit in a different context and pertaining to relief from debt servicing owed to private creditors. The proposal pertains to governments that have lost access to new loans from financial markets and that thus face at least a liquidity problem if not also an insolvency problem. The idea is that the private creditors (or some major subgroup of them) would "voluntarily" agree to delay debt servicing during the period of a country's agreed IMF adjustment program. The delay could take the form of rescheduled loan repayments to banks or exchange of bonds for new ones that matured later.[7]

This approach harks back to the early stages of the 1980s sovereign debt crises in which committees of major bank creditors, known as Bank Advisory Committees or London clubs, were formed in which to forge agreements to provide "concerted" funding of debt-servicing obligations to the banks that the debtors could not meet on their own. In that series of crises, the authorities overseeing the major international banks worried that a default by Mexico and then others would have collapsed the banks. They had been deeply exposed to the heavily indebted countries of those years and they operated the major foreign exchange markets as well as were heavily engaged in the short-term financing of the major capital markets. Thus, concerted or "forced" lending was arranged in concert with the banks, while the regulators of the banks exercised forbearance in not making the banks recognize those loans as "impaired". In fact, the debtor governments had become insolvent, although the policy to address their problem assumed they were only illiquid. It was not until the end of the decade after the rebuilding of bank capital and reserves that the Brady Plan was put forward to remove the debt from the banks' books.

While London clubs might be again envisaged for dealing with bank loans in the illiquidity situations the IMF envisages, procedures are less settled for mobilizing the bondholders. In this regard, a serious challenge to the proposal has been made by an ad hoc group of experts that met in November. In their view, "voluntarily" delaying payment, somehow concerted, is "merely a delicate way of describing default."[8] Default has more severe consequences than voluntary swaps as bondholders could then

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[5] See Henry Northover, "Human development advocacy for debt relief, aid and governance," in Herman, Ocampo and Spiegel, eds., op cit., , pp. 298-314.

[6] United Nations, "Guiding principles on foreign debt and human rights," Report of the Independent Expert on the effects of foreign debt and other related international financial obligations of States on the full enjoyment of all economic, social and cultural rights, Cephas Lumina (A/HRC/20/23), paras. 20 and 21 (endorsed by the Human Rights Council in resolution 20/10, 5 July 2012).

[7] IMF, "Sovereign debt restructuring—recent development and implications for the Fund's legal and policy framework," April 26, 2013, para. 32.

[8] Douglas Baird et al., "The role of the IMF in future sovereign debt restructurings," University of Southern California, Gould School of Law, Center for Law and Social Science, Research Papers Series No. CLASS13-6,

"accelerate" their bonds and demand immediate full repayment rather than accept to swap into a bond with longer maturity. Default would also trigger payments on credit default swaps, offering ready cash to the bondholders instead of a longer-dated new security of uncertain value. This had been a concern in the case of Greek bond restructurings. Indeed, no "credit event" to trigger payment under Greek credit default swaps was recognized until Greek legislation changed the terms of the bonds that had been issued under Greek law, at which point it was no longer possible to maintain the fiction that the swap of new bonds for old was "voluntary".

In other words, it is not clear the proposed maturity bond swap would get the required supermajority of bondholders agreeing in this situation. Unlike in the London clubs, there would be no invisible regulators who hovered over the banks as they discussed restructuring of the repayments. Although the IMF paper did not mentioned it, it thus seems that the "voluntary concerting" of bond creditors would need to be complemented with some way to maintain the fiction of voluntariness and there would need to be some legal form of stay on bondholders who might otherwise "race to the courthouse" to claim default had occurred and demand immediate payment of the full face value of their holdings.

In their proposal, the Fund staff noted a need to revise the contractual terms of sovereign bonds, but they did not address the need for a stay on litigation. The focus was rather how to better coordinate the maturity-bond exchanges in all the various outstanding series of bonds issued by the debtor country. While this "aggregation" problem might be handled adequately through new contract clauses, it seems that an explicit statutory approach would also be needed to stay the holdouts in the courthouse, such as an amendment to the IMF Articles of Agreement (which would bind all member countries), or perhaps some common legislation in the major financial centers. In fact, these statutory alternatives form part of an academic proposal for the insolvency case to be described below that is rumored to also reflect IMF staff views.

Insolvency

Insolvency means there is no reasonable prospect that the debtor can repay all its creditors in full, let alone on time. One may ask how governments can get to such a situation as lenders usually have the option of not lending. One way obviously is lack of information, as when the creditors do not know how much the borrower owes to other creditors. This is the "asymmetric information" case in spades. Indeed, political leaders of governments in debt trouble have every incentive to hide their actual situation, buying time if only in hope for a miracle that rarely arrives.

If one wanted to create disincentives to insolvency of governments, as well as be able to monitor the fairness of debt workouts, a first policy would be to make the debt situation always transparent to creditors. This is a central part of the advocacy by creditor groups such as the Institute of International Finance (IIF) on the private creditor side, and warrants the joint official collection and reconciliation of information on sovereign debt, both the claims of creditors and the acknowledged obligations of

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debtors, as is now routinely carried out by international organizations.[9]

In addition to better tracking and publishing the debt explicitly on the government's books, the amount of "contingent liabilities" and the probability that the government will have to assume responsibility for them need to be addressed in a straightforward way. These typically include unfunded promises to deliver pensions (as in numerous towns and cities in the United States) and circumstances under which the banking system's obligations might be taken over by the government (as in Ireland and Spain). The information on explicit and contingent liabilities should be available to citizens and their legislative representatives in easily understood ways, as they will be obligated to pay heavily in the insolvency workout. This is not usually emphasized enough.

But even when creditors know the sovereign borrower's situation, private creditors have an incentive to lend if the term is short and the interest rate high. Although one might say that it is "stupid" to lend money to an insolvent debtor, a special aspect of sovereign debt makes it only "somewhat stupid". That is, all unsecured debts of a sovereign formally have equal seniority (the higher seniority of IMF and other IFI debt is a tradition not a law, but it is observed and so this discussion excludes obligations to the IFIs). Thus, if the debtor government can be presumed to have a fixed repayment capacity, one that is lower than its obligations, then the last lenders to an insolvent government going bankrupt reduce the repayment to all other creditors proportionally (excluding IFIs), meaning the last lender is as likely to get a share in the limited feasible repayment as the oldest creditor. In other words, the last lenders dilute the debt recovery by the other creditors.

Addressing this issue would create a strong disincentive to creditors to lend and lend until the borrowing government becomes insolvent and would also lead to a different debt crisis resolution process. That is, instead of treating all uncollateralized obligations of the government as of equal seniority, it is proposed that creditors have differentiated seniority. In particular, the last lenders would be sent to the back of the queue. Once into explicit insolvency under some form of international supervision, the government would be empowered to borrow again from private lenders because the new creditors would be put at the front of the queue, as in "debtor-in-possession financing" in corporate bankruptcy in the United States. Such a change, initially proposed many years ago by Patrick Bolton and David Skeel, has not attracted serious policy attention as yet.[10] However, it has various features to recommend it, including that it reduces (even removes one might say) the need for official bailout financing.

While the Bolton/Skeel proposal thus far lies untouched, there has recently been renewed interest in some sort of more limited reform of policy for workouts from sovereign insolvencies. The IMF proposal noted above to defer payments temporarily can also help in a case of insolvency, since it would not raise the debt level; or rather, more precisely, the present value of the debt should not rise, as long as the

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[9] See IIF, "Principles for stable capital flows and fair restructuring and addendum" in Report of the Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Resolution, Washington, D.C. October 2012, and Joint External Debt Hub of the Bank for International Settlements, IMF, Organization for Economic Cooperation and Development and World Bank (www.jedh.org).

[10] The proposal is developed in a number of papers, including "How to rethink sovereign bankruptcy: A new role for IMF?" in Herman, Ocampo and Spiegel, op. cit., pp. 449-485.

refinancing did not impose a punitive interest rate. Indeed, it was recommended as a device to buy time while better assessing the degree of debtor need for relief. If the debtor country is found to be insolvent, the debt needs to be actually reduced to return the country to a sustainable debt situation. A new proposal has been made in this regard by a group of academics.

The key innovation in the new proposal, which is being associated with the Brookings Institution in Washington, D.C. because it hosted the meeting at which the proposal was drafted, is to establish a debt workout facility in the IMF.[11] This "Sovereign Debt Adjustment Facility" would both coordinate debt restructuring and offer IMF loans to the insolvent country under the condition that it obtains adequate debt relief from its creditors and adopts an IMF adjustment program. In other words, the IMF would oversee an adjustment program that would be financed in part with debt relief and in part with new IMF loans. In this way, IMF would not be bailing out the other creditors.

To qualify, countries would first have to be deemed to have reached an insolvent condition, based on various criteria that would be specified in advance by the Fund, much as had been the case for the countries covered by the Heavily Indebted Poor Countries (HIPC) Initiative. Once granted that status, the Fund would assist the country in developing not only an economic adjustment program but also a debt sustainability analysis (DSA) that included what would be considered the necessary overall degree of debt relief. The paper (and presumably the adjustment program as well) would be posted on the Internet and comments from interested parties welcomed, possibly including through a public hearing on the proposal. A revised DSA (and perhaps a revised adjustment program) would then be issued, which the debtor would then use in its negotiations with each of its creditor groups, with IMF in the end insuring that the overall debt reduction met the amount that had been deemed necessary in the final DSA. The Fund would then complement the debt relief with its own lending.

Except for the offer of IMF financing at the end of the process, the proposal has characteristics of a bankruptcy court, with IMF (in fact, its Executive Board) playing the role of the judge who has to approve the negotiations that the firm holds with its different classes of creditors. In addition, as in corporate bankruptcy, holdout creditors would be prohibited from disrupting the debt negotiations. In this case, a two-pronged strategy would be employed. One prong would be to introduce stronger collective action and aggregation clauses in new bond contracts to more clearly define the supermajorities needed to approve a change in the bonds and thus the conditions for the "cram down" on the unwilling minority bondholders (this repeats the Fund proposal on liquidity refinancing). The second prong would legally prohibit individual non-cooperating creditors from taking ownership of any assets of the indebted country government, regardless of what some friendly court might decide (an allusion to the case against Argentina in the New York courts). The latter provision could be adopted as a new amendment to the IMF Articles of Agreement, or legislation might be adopted in relevant countries to prevent holdouts from attaching payments that the targeted sovereign would normally make through Euroclear or other parts of the international financial plumbing that those governments hosted. In either

[11] Committee on International Economic and Policy Reform, "Revisiting Sovereign Bankruptcy," Brookings Institution, Washington, D.C., October 2013. The committee also made a proposal for a sovereign debt restructuring mechanism within the European Union, which we do not address here.

variant, the proposal needs this legislative dimension, as seemed to be the case as well for the maturity-extending bonds noted earlier.

Who should do what, where?

These new proposals to handle illiquidity and insolvency problems of governments have put IMF at the center of the discussion. In one sense, this is the obvious and proper place for them in that the IMF was created by the international community of nations to manage international financial matters of countries. It is the place in the network of international organizations where the macroeconomic mandate and considerable expertise lies and it has built up its technical capacity in issues of financial market oversight in recent decades (although regulatory responsibilities lie with other entities, such as the Basel Committee on Banking Supervision and other bodies coordinated by the Financial Stability Board, in turn overseen by the Group of 20).

However, the IMF is not a popular international institution. It has been roundly and consistently criticized for being too friendly to the financial industry, pushing developing countries too hard—and developed countries as well, since the recent spasm of cases, particularly Greece—in which the Fund insisted on excessively austere adjustment programs. One could say that although countries abolished debtors' prisons for people, they together created a prison for debtor countries.

As harsh as are the comments made about the IMF from the side of civil society, academia and debt crisis countries, one can also find harsh criticisms of IMF from the international financial industry, which sees IMF as a political organization. It is said to make decisions to advance the foreign policy of its major shareholders, which in the industry view are not always in concert with those of finance. Thus, the IIF Principles for Stable Capital Flows and Fair Restructuring can be said to have offered debtor countries a bank-centered forum for macroeconomic adjustment, financing and debt relief as an alternative to IMF.[12]

Sometimes, Fund staff will say off the record that the policies they required of governments and the financing they extended were demanded by the US Treasury, as in the extraneous conditionality requirements for some countries during the Asian financial crisis and in extending the final IMF loan package to Russia before its 1998 default. Perhaps they say the same more recently about the German Government, as in southern European austerity programs. In some cases, political influence worked in positive directions, as in the British advocacy for the HIPC Initiative, albeit perhaps countered by its enthusiasm for "light touch" regulation of financial institutions in the same era.

So, yes, the IMF is a political institution as well as a financial one. One alternative, sometimes proposed, is to instead situate a debt workout mechanism at the United Nations. But such a forum would be no less political. One would just change the primary ministry involved from finance to foreign affairs. Some people would welcome this as a way to bring more of a human rights framework into the decision making on sovereign debt workouts. Others might note how contentious human rights deliberations are

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[12] See Barry Herman, "Why the code of conduct for resolving sovereign debt crises falls short," in Herman, Ocampo and Spiegel, eds., op. cit., pp. 389-427.

at the UN. Indeed, although votes at the UN are allocated differently than at IMF, if consensus were required for approval of a debt workout the results might not be so different or no agreement might be reached, leaving the debtor country in a quandary.

All of this leads to the question of whether an independent body could take the responsibility for organizing sovereign debt workouts, on the model of the independence of court systems (although, in truth, judges are often political beings as well). Many proposals from civil society, academia and even the legal profession, have sought to go in this direction, none with political "legs" thus far. Perhaps one reason is the unanswered question of who would enforce the decisions of the independent body on sovereign debtors or on private and sovereign creditors.

And so, here we are with some recent interesting proposals that put IMF at the center of the action. The proposals have not explicitly addressed some issues, such as whether all creditors, including government creditors (both Paris Club members and non-members) and IFIs if needed, would participate in the workout. But the framework of the insolvency proposal could include them as creditor groups required to participate under specified conditions. The benefit of putting the IMF at the center of the proposal is it would have the power to bring all the parties together to reach a solution (both "soft power" and potential Executive Board decision making). The reasonable fear is that the decisions would not satisfy human rights and social obligations in the debt-crisis countries. IMF's former chief legal officer has famously drafted an opinion that IMF is not bound by international human rights treaties, but that the shareholders in IMF could change that by amending the Articles of Agreement, which they have pointedly not chosen to do.[13]

Debt workout reform proposals that are deemed serious by important political actors all revolve around the IMF, a potentially powerful but, shall we say, flawed institution. First best would be to fix the IMF. Second best might be to seat any reform proposal in a new independent body affiliated with a credible international legal entity. Proposals for how to actually accomplish the first or even second best options would be welcomed.[14]

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[13] François Gianviti, "Economic, social and cultural rights and the International Monetary Fund," Seminar on Current Developments in Monetary and Financial Law, IMF, Washington, D.C., May 7-17, 2002 (http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/gianv3.pdf).

[14] A third and softer approach is the proposed Sovereign Debt Forum, which would first function as an informal facility to develop expertise in sovereign insolvency workouts and in time offer to assist debtor governments seeking a neutral intermediary in working towards a cooperative debt crisis workout (see Richard Gitlin and Brett House, "A blueprint for a sovereign debt forum," Center for International Governance Innovation, Waterloo, Ontario, January 16, 2014). The aim of that proposal is far more modest than the proposals discussed above.