United Nations Financing for Development Office
The Centre for International Governance Innovation (CIGI)
Commonwealth Secretariat

Report of Experts' Group Meeting on Sovereign Debt Restructuring[1]

Marlborough House, Pall Mall, London
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Executive Summary

- **Lacuna in the existing financial architecture for debt restructuring:** The system lacks a centralized dispute resolution mechanism, enforceable priority rules for creditors and organized representation of all stakeholders. Absent a well-defined regime for sovereign bankruptcy, the analogue of "negotiations in the shadow of the shadow of the courthouse," which lead to more efficient outcomes in domestic bankruptcies is absent in the case of sovereign default. Nor is there any provision of "breathing space" to find a solution and protect against litigation**.** Moreover, judgments passed in one jurisdiction are not enforceable in other jurisdictions.

- **The shift from current to capital account crises makes recent debt crises much larger**: Capital account driven debt crises unfold over a much shorter period of time. This compression of greater adjustment into a smaller timeframe raises the potential costs for debtor countries. It also has implications with respect to the role of the International Monetary Fund (IMF) in lending in order to restore market confidence and stem capital outflows. At the same time, the role of expectations underscores the importance of differentiating between problems of liquidity and solvency, and the possible need for an exit strategy for the IMF and the official sector.

- **Restructurings have become larger and also more complex because of the number and diversity of creditors:** As the size of official interventions has increased, so too has the risk of subordination to private sector creditors that remain should a subsequent restructuring be required. Restructuring have become more complex as the creditor community has become

[1] This report was drafted by James Haley (CIGI) and Benu Schneider (FfDO). It reflects the very useful contributions of Experts' Group participants, but is not a verbatim transcript of the discussion; rather, the key issues discussed have been integrated into a thematic briefing on the issue.

more heterogeneous, with bondholders ranging from investors, pension funds, hedge funds and insurance companies.

- **The nexus between debt restructuring and the highly leveraged banking system has implications for the role of the official sector** and the role of sovereign debt as collateral can have implications for the expansion of credit with debt writedowns.

- **Collective action clauses cannot perform the goals of public policy**: Since the proposal for a statutory Sovereign Debt Restructuring Mechanism was shelved in 2003, efforts to enhance creditor coordination were advanced by the inclusion of collective action clause in new bond issues. These clauses facilitate creditor coordination among creditors of a single bond issue, but cannot resolve the problems of aggregation across different series of bond issues. While an aggregation mechanism is now included in a standardized EU clause, its effectiveness remains to be tested. More generally, the efficacy of collective action clauses is limited; contractual terms cannot take on the role of public policy such as externalities, societal distribution problems and broad equity terms for stakeholders.

- **Creditor committees for effective creditor representation:** A formal creditor committee for creditor coordination has the advantage that committee member will try and bring other creditors on board; "stress test" assumptions on which potential offers are based including the need for the relief requested. It has the advantage of reducing the pressure for public sector intervention with the signal to markets that an agreement is possible and if the committee works well there is the possibility of early access to markets and restoration of growth. The effectiveness of the committee is contingent upon the rules under which it operates, disclosure, adequate oversight of the committee and resolving issues of dispersion of instruments with dispersion in interests and involving different degrees of liquidity.

- **Standstills can be achieved through voluntary and statutory approaches:** An amendment of Article VIII 2 (b) for capital transfer and (or) through inclusion of clauses in bond contracts.

- **Accounting and regulatory frameworks provide a disincentive for debt write-downs:** Basel has changed the regulatory framework to hard binding floors in restricting the use of capital provisioning to facilitate debt writedowns. Since Enron, there is no room for discretion in accounting frameworks in writing down reserves and accounting for asset values. Losses and the way they are dealt with have serious implications for systemic risk and bank stability.

- **Assessments of debt sustainability should be unbiased and transparent**: The IMF's assessments of debt sustainability should be more transparent, although uncertainty will persist owing to the difficulty in assessing the fundamental nature of the debt problem — liquidity or solvency.

- **State contingent debt as instruments for more equitable risk sharing:** Contingent convertible (CoCo) automatically extends the amortization profile in an emergency liquidity requirement, thereby reducing the amount of official sector assistance required and mitigating the problem of subordination of private debt by the IMF or other official support.

- **The creation of a Sovereign Debt Forum:** A non-statutory, independent standing body to identify lessons from past debt restructuring, bridge information asymmetries and facilitate more transparent, predictable and timely treatment of sovereign debt in periods of extreme debt distress.

REPORT

The United Nations Financing for Development office and The Centre for International Governance Innovation (CIGI) convened an Experts' Group Meeting on Sovereign Debt Restructuring in London, England, on September 19, 2012. The meeting was hosted by the Commonwealth Secretariat at its headquarters in Marlborough House, Pall Mall. Private sector representatives, academics, legal experts and officials participated in the meeting, which was held under the Chatham House Rule of non-attribution to facilitate a frank and full exchange of views.

THE STATE OF PLAY OF DISCUSSIONS

The London meeting was the second of two such meetings, with the first Experts' Group meeting held at the United Nations in New York, United States, on May 15, 2012. That meeting closely followed the restructuring of Greek debt, which brought the issue of sovereign debt restructuring squarely back on the international policy agenda.

A decade ago, in the wake of a series of devastating crises beginning in Mexico in 1994 and culminating with Argentina’s default in December 2001, the international community explored a range of possible options to facilitate timely, orderly restructuring of sovereign debt. The objective of those discussions was to augment the international adjustment toolkit in cases where debt burdens had become so high that they were widely viewed as unsustainable, and possibly posed a risk of distorting the incentives to pursue sound macroeconomic policies, with spillover effects to neighbouring countries and the global economy more broadly.

These efforts to develop a better framework for the timely, orderly restructuring of sovereign debt were marked by cleavages between those prepared to support so-called "voluntary" approaches, in which bondholders would accept contractual modifications that facilitated restructuring, and those who supported a more formal, statutory approach — the Sovereign Debt Restructuring Mechanism (SDRM) — as developed by the IMF under then-First Deputy Managing Director, Anne Krueger. In that event, the decision was taken to abandon statutory approaches in the wake of successful concerted efforts to include collective action clauses (CACs) in new bond issues of key emerging market economies, which have become the *de facto* "boilerplate" of bonds issued under New York law.[2]

The issue of sovereign debt restructuring fell off the international policy agenda as a result of the ample global liquidity and the benign global environment that preceded the global financial crisis, which may have led policy makers and private investors to discount the risks associated with sovereign lending. After a hiatus of several years, however, the protracted debt problems of some euro-zone members have reanimated the debate on sovereign debt restructuring.

In this regard, Experts' Group meeting participants reviewed the underlying motivations of earlier efforts to develop a better framework for the timely, orderly restructuring of sovereign debt. These efforts reflected the perception that the *status quo* increased costs on all parties:

- Creditors are harmed by protracted negotiations, as asset values are dissipated by continuing uncertainty and possibly bad policies;
- The debtor is adversely affected, as growth falls, unemployment rises and support for sensible, sound economic policies erodes; and
- The IMF's credibility and effectiveness in assisting its members to strike a judicious balance between financing and adjustment are impaired.

The London Experts' Group meeting explored how to improve the framework for restructuring in order to reduce the protracted nature of the renegotiation process, return the country to a sustainable growth path sooner, and preserve the bonding role of debt in order to reduce these deadweight losses. In some

[2] Such clauses have long been standard features of bonds issued in London.

respects, the goal can be thought of as replicating the framework for restructuring provided by domestic bankruptcy regimes. But, as one participant pointed out, given the absence of legally enforceable judgments, restructurings must be "messy," in terms of imposing costs to the sovereign borrower, otherwise the bonding role of debt could be eroded and restructurings would be too frequent.

At the same time, participants acknowledged that how restructurings are managed *ex post* will affect creditor and debtor behaviour *ex ante*. Accordingly, efforts to develop a better framework for the timely, orderly restructuring of sovereign debt would help finesse the dynamic inconsistency problem confronting the public sector that arises once it is realized that a member has slipped from sustainability to unsustainability: absent some framework that contains the cost of saying "no" to more financing, efforts to avoid countries "gambling for redemption" on IMF resources will not be credible; and if these efforts are not credible, they will not affect behaviour.[3]

Participants also discussed key gaps between domestic bankruptcy procedures and the current international framework for sovereign debt restructuring. These gaps include differences in the incentive structures for restructuring — in contrast to domestic bankruptcies interest accrues in international sovereign restructurings reducing the incentive for creditors to consider timely restructurings. Other fundamental structural differences are the absence of a centralized dispute resolution mechanism, enforceable priority rules and the absence of organized representation of all stakeholders, which, it was argued, pose two challenges. The first reflects the fact that, while sovereign debt restructurings are international in terms of their consequences, the doctrine of sovereign immunity implies that judgments in one jurisdiction do not result in international enforcement.[4] The second

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[3] Dynamic inconsistency (or time inconsistency) refers to the problem that pre-commitments designed to achieve a particular outcome may become incredible if certain conditions are not satisfied; indeed, following through on the pre-commitment may result in a strictly inferior outcome. As a result, following through on the prescribed action is not dynamically consistent. With respect to sovereign debt restructuring, for example, it has been argued that the prospect of IMF financing encourages creditors to delay needed negotiations and for borrowers in distress to "gamble for redemption" even though such choices increases the deadweight losses suffered by both parties. Strict limits on IMF financing would, it is argued, force timely, orderly and "voluntary" restructurings. And, yet, the potential consequences of a crisis, should creditors and borrowers fail to agree on a restructuring of claims, renders threats to withhold official sector resources incredible.

[4] This said, it was noted that ongoing litigation with respect to Argentina's 2005 bond exchange has the potential to fundamentally alter the status quo with respect to the doctrine of sovereign immunity. A recent ruling by the

challenge that must be addressed is defining the extent to which 'hard' rules – presumably with domestic legal backing – are required, particularly in terms of enforcement of judgments and the provision of a "breathing space" providing protection against litigation. Given the present lack of support for international bankruptcy provisions, however, the ongoing discussion to improve the environment for sovereign debt restructurings is coming from voluntary initiatives.

Creditor Coordination

Timely, effective creditor coordination is critical. In this respect, the Experts' Group meeting reviewed the evolution of practice to organize effective creditor representation. It was noted, for example, that in the 1980s, when foreign bank lending constituted the bulk of total claims on sovereigns, bank steering committees were the key negotiating body. Bonded debt was deemed *de minimus* in those earlier restructurings and largely escaped unscathed. By the 1990s, however, bonded debt represented the bulk of claims on sovereigns, as commercial banks were replaced by bondholders that, by definition, were more heterogeneous and highly dispersed.[5] This structure of outstanding debt led to concerns that difficult, protracted restructuring negotiations would increase deadweight losses.

Since the late 1990s, the actual experience with voluntary debt exchanges has been encouraging. Two models have governed these restructurings. Under the first model, the debtor engages a debt advisor to take informal "soundings" of creditors' willingness and flexibility with respect to possible restructuring. The goal is to assess expressions of view, rather than formal commitment, with which to develop restructuring offers.

New York court now under appeal, if upheld, would have the effect of estopping financial intermediaries from processing payments to bondholders that accepted restructured bonds unless and until holdout investors are made whole. This will likely be a source of uncertainty for some time, as the case will be appealed regardless of the decision in the lower court.

[5] This episode neatly illustrates the point that the nature of the capital structure is not independent of the underlying legal and institutional structures. Bonded debt increased in importance in the 1990s because it was thought to be immune from restructuring based on earlier experience. Such expectations were subsequently frustrated, as in the case of Pakistan, for example. Moreover, more recent innovations with respect to the contracting technology, including the use of exit consents, greatly assuaged creditor coordination problems among a highly defused and heterogeneous bondholder community. Of course, these developments can be expected to elicit further contractual innovations to protect minority stakeholders. Recent judicial interpretations of *pari passu*, if upheld on appeal, can be expected to lead to still more changes.

The second model used to facilitate voluntary bond exchanges features the appointment by the sovereign of a formal creditor committee. This approach has several benefits, including the opportunity to "stress test" assumptions on which potential offers are based, particularly whether the requested debt relief is commensurate with the need. In addition, the committee has the capacity to give a proposed restructuring a "good housekeeping seal of approval" and increase the likely acceptance by the creditors whom they represent. In this regard, there is also an implicit understanding that committee members will work to "bring other creditors 'on board' the agreement." The Experts' Group learned that, by demonstrating positive, collaborative efforts, this approach reduces the pressure for public sector intervention and helps to convince markets that an agreement is possible. In the best circumstances, the result can be an early restoration of credit market access and a return to growth.

Unfortunately, a number of factors can block this felicitous outcome. It was noted, for example, that if the committee fails to agree, a proposed restructuring is "dead on arrival." The rules under which a committee operates and the underlying characteristics of outstanding claims, meanwhile, have direct and significant impacts on the process: committee structures governed by unanimity and restructurings involving a wide dispersion of instruments, with a corresponding dispersion of creditor interests, will be more problematic. Similarly, debt restructurings involving assets with different degrees of liquidity may be more difficult to resolve as membership in the committee may shift with changes in beneficial ownership. Finally, the disclosure of confidential information received by members of the committee is problematic — some creditors may prefer to remain outside the committee process in order to retain the prerogative to continue trading, rather than agree to the terms of confidentiality agreements.[6]

Against this background, the Experts' Group meeting reviewed several options for facilitating creditor coordination. One option would be to resurrect standing committees of creditors, such as the Foreign Bondholders Protective Council, that led negotiations in earlier historical debt restructuring episodes. *Ex-ante* structures for creditor bodies with an oversight structure and balanced governance body may be the solution.

[6] The landmark Belize restructuring of 2006 finessed this problem by full, open public disclosure: since members of creditor committees did not have access to private information, concerns of non-disclosure did not apply.

Other alternative ideas floated by participants were to provide provisions to facilitate coordination that could be built into bond contracts, similar to bondholder committee modalities in UK law. Alternatively, greater use could be made of trustee provisions, which would prescribe clearly defined duties and responsibilities in the event of restructurings.[7]

Collective Action Clauses (CACs)

Participants also discussed the evolution of CACs and whether it is possible to replicate domestic bankruptcy regimes through contractual terms. The policy goal when the big push came for CACs in 2003 was to solve the unanimity problem and subsidiary problems. While important progress has been achieved in incorporating CACs over the past decade, as noted above, one participant noted forcefully that a purely contractual approach has severe limitations. CACs, it was argued, can help resolve creditor coordination problems, but are a poor substitute for more formal bankruptcy regimes. The reason for this is that bankruptcy regimes deal with externalities, societal distributional problems and broad equity concerns regarding stakeholders widely defined, all of which are the domain of public policy — not private interests. It would be unwise, therefore, "to burden a worthy individual contractual term with public policy objectives." It would not be appropriate for contracts to make economic policies. Recent litigation surrounding the use and interpretation of *pari passu* clauses is a case in point: while individual creditors have a clear interest in enforcing such covenants, their enforcement, as currently subject to judicial interpretation, could gravely undermine the principle of sovereign immunity and impair the ability of severely distressed sovereign borrowers to secure restructuring agreements broadly acceptable to a supermajority of creditors.[8]

Accounting and Regulatory Treatment

At the same time, regulatory and accounting practices can influence the timing and the extent of debt restructurings. It was noted, for example, that the 1987 Brady bond operation that unblocked debt

[7] As noted below in the context of proposals to introduce standstill arrangements, note 12, trustees are typically reluctant to assume too much delegation of responsibilities, given the potential risk of litigation for non-performance of fiduciary obligations.

[8] Creditors that would otherwise be prepared to agree to a restructuring conditional on supermajority approval, would be reluctant to participate if there is a significant risk that so-called 'holdouts' could use a *pari passu* clause to block restructured bond payments in order to recover full value on their initial investments.

reduction for many Latin American sovereign borrowers was facilitated by favourable regulatory treatment in an environment in which national regulatory authorities exercised considerable discretion. This soon changed, however, as a result of the 1988 Basel Accords. As one participant put it: "Basel moved [the international regulatory framework] from desideratum to hard binding floors in restricting the use of capital provisioning to facilitate debt writedowns." Accounting practices have also changed in fundamental ways. As one Experts' Group participant noted, the prevailing view prior to the Enron scandal was that assets were best valued by the party with the most information (management). Subsequent to the scandal, there is no room for discretion in writing down reserves and accounting for asset values. These factors can be important determinants of debt restructurings.

There is a greater risk associated with bank stability. Within the country, the risks with respect to banks stem from losses that could imperil the banking system and result in systemic effects across the economy. Outside the country, debt write downs are deductible, posing fiscal challenges for the government of the country in which the bank is incorporated, which will bear a percentage of the losses, in cases of limited exposure, but not potential systemic threats. The danger of systemic risk is heightened and the challenges to crisis resolution and management magnified when the amounts may be sufficiently large to cause systemic risk. The risk is further aggravated by the lack of information on losses in cross-border flows.

Designing the analogue to domestic bankruptcy procedures for international bankruptcy

Participants also discussed the characteristics of a well-designed domestic bankruptcy regime that assuages coordination problems and promotes wealth maximization, namely:

- *facilitating debt discharge* to avoid the perverse incentives created by a debt overhang;
- *limiting asset seizures* and creditor runs in the restructuring process and preserving asset values; and
- *reducing the scope for rogue creditors*, or less pejoratively, "opportunistic behavior," to disrupt restructurings broadly acceptable to the (super) majority of creditors.

Debt Reduction

At the sovereign level, absent some formal international bankruptcy court, the equivalent of debt discharge is determined by bargaining between the creditors and the debtor over the size of prospective "haircuts" or reductions in net present value of the debt. The key issues here are debt sustainability assessments and the degree of fiscal adjustment that can be sustained over time. Of course, views on these issues differ between creditors and the debtor, creating the potential for protracted disputes that can delay needed reforms and dissipate asset values.

In theory, the IMF can play the role of disinterested third party, providing advice on these matters. Yet, as crises have grown and IMF programs have increased in size, concerns have emerged that the IMF can no longer provide unbiased estimates of the feasible adjustment effort that heavily indebted borrowers can sustain. In this respect, the Experts' Group heard the view that the "IMF's black box for debt sustainability analysis has changed inexplicably [over the past two decades]; that the factors that influenced the IMF's assessment were not transparent." It was noted, meanwhile, that the private sector is receptive to the IMF's involvement in the process, but that there must be transparency with respect to how the IMF conducts its debt sustainability analysis. As one participant observed, this might require the IMF to share with private creditors its spreadsheets detailing the country's debt-servicing capacity, financing gap and debt dynamics.[9]

The potential for the IMF's preferred creditor status to subordinate private claims heightens these concerns. As one participant observed, the sovereign debt restructurings of the 1980s were conducted with "very little IMF money on the table." In contrast, it was noted, more recent experience has witnessed large IMF financial packages that have allowed other creditors to get away without a haircut.

[9] In fairness to the IMF, the nature of debt problems has evolved considerably since the 1980s. Earlier debt crises unfolded in an environment of limited capital mobility and controls that largely limited balance of payments difficulties to problems of the current account, or gaps between national savings and investment rates — typically a few percentage points of GDP. In contrast, since the early 1990s, international financial crises have emerged from capital account crises, which can be resolved by early action to restore market confidence to stem capital outflows. However, the goal of timely, concerted action to restore confidence could, it might be argued, be inconsistent with the goal of transparency.

The problem is that, while some investors escape unscathed, increased official sector money magnifies the risk of subordination to the private creditors that remain.[10]

At the same time, uncertainty regarding the fundamental nature of the debt problem — whether it is liquidity or solvency — and the capacity of creditors to absorb losses associated with asset writedowns and/or reduced income streams are also an important consideration. As the Experts' Group meeting heard, the successful resolution of the Latin American debt crisis was likely delayed by changing perceptions of the situation. As one participant argued, "Only time can tip the balance one way or other [in support of a restructuring] on the basis of policies adopted and market assessment of the external environment." In this regard, in the 1980s, it took time for creditors to appreciate that the problem was excessive debt burdens, not a temporary lack of liquidity, for which rescheduling and new money was an appropriate response. Moreover, it took time for commercial bank creditors to build the reserves necessary to contemplate debt reduction or, as one participant argued: "the speed of resolution is determined by the speed at which creditors can absorb losses."[11]

A comparison between IMF interventions in, say, the 1980s and more recent involvement is instructive. In the earlier period, the IMF largely played a "catalytic" role through its monitoring of countries' policies. With the debt crisis initially viewed as a temporary liquidity problem, the IMF was, in effect, a bonding mechanism to enforce highly indebted countries' commitments to adopt structural reforms. These reforms were needed to give commercial bank creditors the confidence to rollover, reschedule and provide new money as required to 'bridge' to the stronger growth that these structural reforms would deliver. Higher growth would reduce debt/GDP ratios by growing the denominator. At the same time, the IMF mobilized as the *quid pro quo* for the difficult reforms that countries would introduce.

[10] As one participant pointed out, the refusal of the ECB to participate in the Greek restructuring is difficult to reconcile with more recent initiatives, such as open-ended monetary transactions in which the ECB has waived its preferred creditor status and is prepared to share losses with private creditors on a *pari passu* basis.

[11] While this assessment is unquestionably valid from a pragmatic policy perspective, it is a most unsatisfying result from the perspective of broader equity and stakeholder considerations discussed above. The protracted nature of the debt crisis of the 1980s led to the lost decade of Latin American growth, which retarded development and, arguably, imposed costs on those least able to bear them — the poor of Latin America. This situation had negative spillover effects, including increased social and political instability. In the domestic context, such externalities militate for bankruptcy regimes that balance the interests of a wide set of stakeholders and encompasses such broad considerations as equity and the external effects of liquidation.

Eventually, this strategy was replaced with debt reduction through Brady bonds, but only after commercial bank balance sheets had recovered sufficiently to absorb the financial consequences.

Since the early 1990s, however, international financial crises have emerged from capital account crises, which are much larger and which unfold over a much shorter period of time. This compression of greater adjustment into a smaller timeframe raises the potential costs of crises and, from the IMF's perspective, underscores the need to move quickly to restore market confidence to stem capital outflows. In these circumstances, the challenges confronting the Fund are correspondingly more complex, given that there is not a unique equilibrium.

Standstills and Protection from Litigation

Participants at the Experts' Group meeting discussed the potential role of a standstill in ruling out bad outcomes and supporting favourable outcomes in the context of potential multiple equilibria. The story here is analogous to the use of "bank holidays" to prevent destructive panicked runs by depositors in a bank run equilibrium. In the context of a sovereign debt crisis, the crisis erupts with foreign creditors triggering a "run" on the fixed stock of foreign exchange reserves at the central bank. If the stock of outstanding short-term foreign debt exceeds foreign exchange reserves, a currency crisis would result.

As the Experts' Group discussed, it is important in this regard to distinguish between domestic and foreign debt. Domestic debt, it was argued, carries less risk. In part, this reflects the fact that the central bank can be employed to help address the adjustment challenge through recourse to the inflation tax. Foreign debt, in contrast, is potentially far more problematic. The reason, of course, is that foreign debt carries the risk of currency mismatches and potential exchange rate crises.[12] Foreign debt denominated, say, in US dollars represents a claim on the foreign exchange reserves of the central bank. With the stock of such claims typically far in excess of actual reserve holdings, there is a problem of ill-defined property rights over the foreign exchange reserves and a common pool problem that creates the

[12] A currency mismatch arises when debt is denominated in one currency (US dollar) while the resources from which the debt is serviced are denominated in the domestic currency. In the event of a currency crisis that leads to the depreciation of the domestic currency in terms of the dollar, the mismatch between the two results in an effective increase in debt. In this scenario, a liquidity crisis that triggers currency depreciation could quickly cascade into a solvency problem, as the domestic currency value of the debt burden is increased and the economy is squeezed by debt-servicing efforts.

incentive for creditors to exchange a domestic-currency-denominated asset for the dollar-denominated asset. Yet, given sequential debt-servicing constraint, not all creditors will succeed in making this exchange. As a result, there is an incentive to move first. But if all creditors think in the same manner, all will seek to exchange their claims, exhausting the foreign exchange reserves and precipitating a crisis.

The costs of such crises can also mount significantly because of relationships between sovereign debt, banks, and the financial system more broadly. The danger is that banks holding large stocks of sovereign debt would be rendered insolvent under debt restructuring scenarios. Since the loss of the banking system could result in catastrophic economic disruption to the economy, governments are reluctant to contemplate necessary restructurings; rather than address the problem of excessive debt in a timely manner, governments prevaricate, hoping for a reversal of fortunes in a "gamble for redemption". The Experts' Group meeting also heard a forceful presentation on a potentially far more damaging systemic threat: the nexus between debt restructuring and the highly leveraged financial system. The problem, it was argued, is the role of sovereign debt as collateral supporting a huge expansion of credit through formal and informal (so-called "shadow" banking) markets. The concern is a massive contraction of credit as the value of sovereign debt held as collateral is marked down in restructuring operations.

Under most domestic bankruptcy regimes, a court-sanctioned stay on proceedings and debtor-in-possession (DIP) financing, which accords priority to new lending to a firm undergoing a court-supervised restructuring, reduces the costs of damaging creditor runs. In a sense, the *quid pro quo* to the creditor is the breathing space provided to the debtor to reorganize and propose an orderly restructuring; similarly, while new lending under DIP financing enjoys priority, it helps preserve the asset values of all creditors by, for example, keeping the firm in operation, preserving the capital of the firm as a "going concern" and allowing the introduction of measures to return the operation to profitability. Protection from litigation benefits creditors by preventing the rush to the courthouse and the dissipation of assets through a disruptive liquidation of assets under fire sale prices.

IMF assistance can be thought of as the analogue of DIP financing for sovereigns, as the IMF extends support only if the member is already confronting severe financial difficulties, and its support is intended to stabilize the situation to the benefit of all creditors. Conceptually, the provision of a lender

of "first resort" facility could serve to preclude the "bad" equilibrium by removing the threat of a shortage of foreign exchange reserves.

At the international level, meanwhile, a standstill that precludes the panicked run and allows for the orderly restructuring of claims could, similarly, avoid this disruptive scenario. As one participant argued, in the sovereign debt space, given the deadweight losses associated with an extended limbo period, the potential for multiple equilibria and the consequences of protracted uncertainty, there is an overarching need to focus on growth; in this respect, a well-designed standstill agreement would give the sovereign time to introduce policies that "grow the pie." This being said, in the context of diverse stakeholder/creditor community, there are clear implications for asset valuations. Most important is the issue of inter-creditor equity, particularly between domestic and foreign creditors, given the fact that wealthy domestic residents, who may have preferential access to critical information, typically flee before foreign investors.

The question, then, is benefits resulting from either a "voluntary" approach or, alternatively, creating a framework for the international endorsement of standstill to signal when a country is seeking a breathing space to identify and implement policy reforms that "grow the pie" to the benefit of all.

The conditions that activate the standstill are a key consideration. Under domestic bankruptcy legislation, the "trigger" is clearly defined by the inability of the debtor to meet its payments obligations. At the international level, however, this is much less certain, reflecting the sovereign's ability to raise taxes and/or resort to other mechanisms, including monetary means, to meet its domestic-currency-denominated obligations. Moreover, a sovereign can invoke force majeure to impose a standstill through a suspension of payments.

Participants agreed that there is little appetite for internationally sanctioned standstills as proposed in the initial SDRM proposal, notwithstanding the important safeguards that would accompany formal, internationally recognized protection from litigation. Most important, in this regard, would be the application of IMF conditionality and monitoring that would provide some degree of assurance that the sovereign borrower was implementing policies consistent with asset preservation. In addition, while the suspension of all payments is feasible in a court-administered standstill at the domestic level, this is not

possible in the sovereign context. As a result, some mechanism for monitoring whether payments are value enhancing is necessary. The IMF could, it was proposed, provide that function. Private sector opposition to the initial SDRM proposal focused on the discretion it would assign to the IMF to unilaterally trigger a standstill. A modified proposal (SDRM II), therefore, shifted responsibility for the introduction of a standstill from the Fund to a supermajority of creditors and proposed the use of the Hotchpot Rule, by which the claims of creditors initiating proceedings would be counted against the collective restructuring under the SDRM. As noted above, however, even with these modifications the SDRM proposal lacked broad international support and was shelved.

Efforts to introduce standstills through "voluntary" approaches, meanwhile, could use trustee arrangements, with clear parameters for decision making, consent by representative committees, or embed standstills in private debt contracts. Coordination challenges and potential liability concerns pose obstacles to the use of trustee relationships and creditor committees; accordingly, the most promising voluntary approach is the inclusion of such covenants in collective action clauses.[13]

Provisions for "*Cram Downs"*

The third key objective of sound bankruptcy frameworks is achieved through court-administered cram-down provisions that prevent a small minority of creditors blocking a restructuring plan that could be supported by most creditors. A decade ago, the prevailing view was that coordination problems with respect to bonded debt held by a large, heterogeneous bondholder community would pose an impassible obstacle to timely, orderly restructuring. The SDRM therefore sought to replicate key features of domestic practice. In the event, as one participant argued, "the SDRM failed owing to a lack of political support from key jurisdictions and a fundamental inconsistency in the same institution providing financing and acting as arbitrator." But these failings also serve as "points of reference" going forward. Most important, universal acceptance of a more structured framework for restructuring sovereign debt is not required — only six jurisdictions are required to implement key provisions and

[13] Trustees are wary of too much discretion, fearing potential litigation. As a result, such arrangements would likely be tightly constrained and apply to only a small subset of possible restructuring scenarios. The probable use of creditor committees, meanwhile, is similarly restricted, given the considerable time to organize and secure consent, which would be incompatible with the need for timely action to prevent asset dissipation. The most promising voluntary approach, therefore, is through insertion in bond covenants.

create a *de facto* international legal framework; while an alternative forum for adjudicating disputes can be identified that, once agreed, would be binding on parties and enforceable.[14]

The decision to defer further work on the SDRM shifted efforts to promote timely, orderly restructurings focused on the adoption of collective action clauses and voluntary codes of behaviour governing the restructuring process. And while CACs have become widely accepted, they are subject to a number of limitations. Most important of these obstacles is the problem of aggregation in which coordination problems across individual bond issues, all of which have CACs and the requisite supermajorities, can block a restructuring plan across the universe of outstanding claims: even if individual creditors or creditor groups are prepared to accept a writedown on their claims, they will be loath to do so if individuals holding other bonds refuse to do likewise. As a result, efforts to reduce the risk of future crises and to secure a better framework for the restructuring of sovereign debt should continue. The danger is that the impetus to follow through on this work will diminish when the global financial crisis recedes and the ongoing debt problems in Europe are resolved.

State-contingent debt

Consistent with the need for continued work, the Experts' Group heard a proposal to improve the framework for sovereign debt structuring through the greater use of state-contingent debt. In some respects, the problem of debt restructuring reflects the absence of complete state-contingent contracts and the inability of governments to credibly commit to sharing upside outcomes. If debt were fully state contingent, with payments conditional on all possible states of the world, there would never be a need to restructure: by definition, the debt contract would contemplate all possible states of the world, including those with very low levels of output in which debt-servicing capacity would be curtailed, and provision for them.[15] In this regard, it was suggested that CoCo debt, which automatically extends the maturity of the sovereign's amortization profile in the event of emergency liquidity assistance, would

[14] The most likely candidate in this regard is the International Centre for Settlement of Investment Disputes (ICSID), an independent, quasi-judicial body for arbitrating and resolving cross-border disputes. As one participant noted, however, ICSID can only function effectively if sovereign states accede to its treaty-like obligations. This would require the political will to pre-commit to arbitration rulings; as the SDRM debate illustrates, such support cannot be taken for granted.

[15] In practice, such an Arrow-Debru economy is, of course, precluded by imperfect and asymmetrically distributed information and bounded rationality that limits the ability of individuals to contract over all possible states.

improve the prevention and resolution of sovereign debt crises. Such instruments would reduce the amount of official sector financing that is required, since sovereign debt amortization payments would be postponed, thereby mitigating the problem of subordination of private claims by IMF or other official sector support.

Concerns were raised, however, that contingent convertible debt might create potential “cliff effects” or discontinuities in financial markets as the financial situation of an issuer deteriorates. Investors with “preferred habitats” seeking to target liquidity and maturity objectives could be tempted to bring the crisis forward in anticipation of a possible IMF rescue. Sovereign issuers, meanwhile, might avoid addressing underlying problems and dissemble with respect to underlying prospects, in the hope of convincing markets that all is well. It was noted, in rebuttal, that forward-looking investors would begin to price in potential activation earlier. This would, it was suggested, introduce a felicitous degree of discipline to the system and is, in fact, a virtue of the proposal.[16]

It was also noted that such instruments could exacerbate the shortage of the high-quality collateral on which so much of the credit generated by the shadow banking system is based. Because the maturity of CoCos is undefined, they would not be capable of serving as collateral to support other transactions.

As Experts’ Group participants discussed, the introduction and widespread issuance of contingent convertible debt would complement other instruments designed to achieve a better sharing of risk, including growth warrants that provide payments to bondholders if growth exceeds a certain level. Warrants were used to “sweeten” the terms of the Argentine and Greek restructuring, as troubled sovereigns asked their creditors to reduce their claims in bad (restructuring) states in return for higher returns in good (upside) states. And, yet, given the potential benefits associated with greater risk sharing, the use of equity-like instruments has been limited to situations of extreme distress. Why is the practice not more widespread?

A possible explanation is that in extremis situations of restructuring, the probability distribution over future states of the world is truncated — in a sense, investors are in the worst-case scenario; there is only upside potential. Warrants offered by the sovereign borrower are thus an incentive to creditors to conclude a restructuring. In times of normal access, in contrast, investors face two-sided risk. Moreover,

[16] As one participant noted, these considerations underscore the importance of carefully considering how sovereign debt trades through the various indices that affect asset valuations throughout the financial system.

sovereign immunity means that there is little creditors can do if governments renege in the good times after benefitting from the state-contingent contract in bad times. At the same time, there is a potential moral hazard problem, in that the contract is priced on variables measured and reported by the issuer. As a result, there is residual uncertainty regarding the monitoring, verification and enforcement of such debt: a government will always want creditors to share in "bad" states; it is less clear that governments will be equally prepared to share in "good" states.[17] Under these conditions, state-contingent instruments are, in effect, insurance contracts for "bad" states; being insurance contracts, investors will price *ex ante* them so as to extract a premium over plain vanilla instruments, which may be subject to *ex post* re-contracting. Governments may be unwilling to issue bonds that carry high premiums today to insure against possible bad states tomorrow.

The implication of this analysis is clear: while growth warrants may help facilitate in the *resolution* of a debt crisis, perhaps as a signal of good faith by the sovereign borrower, they may not play a significant role in terms of crisis *prevention*. As a result, crises will remain a perennial problem.

Sovereign Debt Forum

Another proposal for improving the framework for the timely, orderly restructuring of sovereign debt — is the creation of a Sovereign Debt Forum (SDF) floated earlier in the New York Expert Group meeting. The SDF would provide a non-statutory neutral standing body to identify lessons from past sovereign debt distress, bridge information asymmetries and facilitate more predictable, transparent and timely treatment of sovereign debt in periods of extreme distress. The objective underlying the proposal is to encourage earlier, more rapid treatment of debt-servicing problems by addressing many of the challenges identified above, including creditor coordination, debt sustainability assessments, comparability of treatment issues.

Although the Experts' Group welcomed the proposal, views differed on its likely effectiveness in securing the ambitious goals set for the SDF. That being said, nobody voiced serious concerns that it may

[17] The robustness of these instruments is uncertain. What is clear is that a default on a growth warrant will pose a severe stress test to the market.

impair the restructuring process; in this respect, it passes the Hippocratic test. Moreover, if it could resolve some of the problems that arise under the *status quo*, it is well worth pursuing.

CONCLUSIONS

The London Experts' Group discussion of the current state of play of debt restructuring was productive and informative. While there was consensus on many of the issues discussed, as was the case of the New York meeting, there was no agreement on the need or likelihood of securing a formal statutory framework for international bankruptcy. For the immediate future, therefore, debt restructurings will be guided by practices of the past decade.

This being said, however, it is clear that to get timely, orderly *voluntary* restructurings, there has to be a credible threat of *involuntary* solutions — either by force majeure or through some framework of rules. The domestic analogue is restructurings done in the "shadow of the courthouse" — debtors and creditors know that they can either come to voluntary solution or litigate. From a private perspective, the latter option entails deadweight losses in the form of legal fees and the time lost in negotiations. The point here is that the threat of an involuntary solution "through the courthouse" creates the incentives to do a deal more quickly that preserves the size of the pie to be divided. Moreover, the rules provided by the bankruptcy regime help anchor expectations of the likely outcome of the "involuntary" (litigation) approach. As a result, time and asset values are dissipated in staking out positions that both sides know would not be supported by the disinterested bankruptcy judge. Of course, the rules are not mechanical; uncertainty about the eventual restructuring remains. But the rules reduce confidence intervals around likely outcomes, and this is what fosters timely voluntary restructurings.

Moving forward, some of the challenges are defining a common set of attributes for effective resolution regimes and addressing cross-border issues when multiple jurisdictions are involved. A redesign of the strategy for institutions and sovereigns in distress is needed and dealing with the risk of contagion which a debt resolution may trigger. Proposals to introduce greater certainty of possible outcomes, as the creation of *ex ante* structures of creditor committees, provisions for standstills, more complete contracts, and SDF would do, could replicate this beneficial effect. Because it would not entail the use of limited political capital to put into effect that a formal statutory approach requires, there is considerable

merit in pursuing these initiatives. Other ideas to be brought forward from the earlier expert group meeting are the role of the private sector in debtor in possession financing, thus re-thinking the role of the official and private sector in crisis management and setting up an international debt registry for recording reliable and consistent information on international liabilities reported by creditors and reconciled with debtors.

ANNEX

EXPERT GROUP MEETING ON SOVEREIGN DEBT RESTRUCTURING[18]

Commonwealth Secretariat, Marlborough House, Pall Mall, London SW1Y 5HX, UK

19 September 2012

8:30 – 9.00	**Registration**	
9:00-9:05	**Welcome**	
	Cyrus Rustomjee	Director, Economic Affairs Division, Commonwealth Secretariat
9:00 – 9: 15	**Scene Setting**	
	Benu Schneider	Chief Development Finance & External Debt Unit, FFDO-UNDESA
	James Haley	Director, Global Economy Program, CIGI
9:15 – 9:30	**Gaps in Legal and Institutional Structures for Debt Restructuring**	
	Michael Waibel	University Lecturer, University of Cambridge
9:30 – 10:45	**The Role of Stays/Standstills in Promoting Restructuring**	
	Deborah Nache-Zandstra: Contractually-defined "grace periods"	Partner, Sovereign Debt Restructuring Group, Clifford Chance, London
	Rhoda Weeks-Brown: Statutory standstills	Deputy General Counsel, International Monetary Fund
	Discussant: Marcus Miller	Professor of Economics, Warwick University
10:45 - 11:00	**Coffee Break**	
11:00 – 12:15	**New Financing: Roles of the official and private sectors**	
	Andrew Powell: Exit strategy for the official sector	Principal Advisor in the Research Department, Inter-American Development Bank
	Jeromin Zettelmeyer: Implications of Greek restructuring	Deputy Chief Economist and Director of Research, European Bank for Reconstruction and Development
	Discussant: Rodrigo Olivares-Caminal	Lecturer in Banking and Finance at the Centre for Commercial Law Studies, Queen Mary, University of London

[18] *Organized by the Financing for Development Office, United Nations Department of Economic and Social Affairs (FFDO-UNDESA), The Centre for International Governance Innovation (CIGI), and the Commonwealth Secretariat*

12:15 – 1:00	**The Evolution and Shortfalls of Collective action Clauses**	
	Himamauli Das : Collective Action Clauses (CACs)	Assistant General Counsel for International Affairs, U.S. Treasury Department
	Anna Gelpern: Limitations of CACs	Professor of Law, American University Washington College of Law; Visiting Professor of Law at the Georgetown University Law Center
1:00 – 2:00	**Lunch**	
2:00 – 3:15	**Issues in Debt Restructuring I**	
	Lee Bucheit: Ex-ante frameworks for creditor committees – can they enhance creditor coordination?	Partner, Cleary Gottlieb Steen & Hamilton LLP, New York
	Daniel Cohen: Debt Sustainability	Professor, Paris School of Economics
	Discussant: David Lubin	Global Head of Emerging Markets Economics at Citi
3:15 – 3:30	**Coffee Break**	
3:30 – 4:45	**Issues in Debt Restructuring II**	
	James Aitken: The Bank-Sovereign Debt Nexus—implications for the financial “plumbing”	Founder, Aitken Advisors LLP
	Simon Gleeson: Tax, regulatory and accounting frameworks effects on incentives for restructuring	Partner, Clifford Chance, London
	Gavin Bingham: Bankruptcy of bankruptcy	Partner, Systemic Policy Partnership (SPP); Former Secretary General of Central Bank Governance Forum, BIS
	Discussant: Martin Brooke	Head of International Finance Division, Bank of England
4:45 – 6:00	**Options for Enhancing the Debt Restructuring Architecture**	
	Brett House	Senior Fellow, Jeanne Sauve Foundation; Chazen Visiting Scholar, Columbia Business School
	David Beers	Special Adviser to the Governor, Bank of Canada
	Konstantin Vyshkovskiy	Director, Department of State Debt and State Financial Assets, Ministry of Finance, Russian Federation
	Amar Bhattacharya	Director of the Secretariat, Intergovernmental Group of Twenty-Four