A New Approach to Sovereign Debt Restructuring: Preliminary Considerations

November 30, 2001

PREAMBLE

1. Under the existing international financial system, there is an inadequate range of instruments to facilitate an orderly, rapid and predictable restructuring of sovereign debt in those circumstances where the member's indebtedness is judged to be unsustainable. The establishment of a legal framework to guide the restructuring process could contribute to the achievement of this objective, thereby reducing the cost of restructuring for both sovereign debtors and their creditors.

2. Ideally, a sovereign debt restructuring mechanism would create the incentives for a sovereign and its creditors to agree to an appropriate debt restructuring without having to rely on the actual use of the mechanism. For that objective to be achieved, the operation of the mechanism would need to be sufficiently predictable that the relevant parties are fully aware of the leverage they would possess if it were activated. In the long term, such predictability would facilitate the assessment and pricing of risk and, thereby, greater stability in the international financial system. This would underpin the efficient operation of credit markets and help put capital flows to emerging markets on a sounder basis.

3. The corporate reorganization features of an insolvency law provide useful guidance as to the type of elements that could form part of the legal framework. However, the applicability of this model is limited in a number of important respects by the unique characteristics of a sovereign state. To be effective, the framework would need to include both a stay on creditor enforcement and provisions that make a restructuring agreed upon by a majority of creditors binding on all creditors. Consistent with the approach followed in the corporate model, these provisions would need to be balanced by measures that safeguard creditor interests during the period of the stay.

4. Designing the specific features of the mechanism would require the resolution of a number of complex issues. For example, careful consideration would need to be given to the scope of the debt to be covered. It may be necessary, for example, to include both domestic and external debt under the framework. Moreover, since sovereign financial crises can arise in the context of nonsovereign indebtedness, the framework may need to address defaults arising from the imposition of exchange controls.

5. Even if such a framework were established, it would not resolve a number of difficult issues. In particular:

(a) First, even the most orderly restructuring process will still be costly. For the sovereign, the reputational damage and economic dislocation arising from a restructuring would still be substantial, particularly in circumstances where the domestic banking system holds a

significant amount of sovereign debt. However, these costs could alleviate concerns that the establishment of a legal framework would create moral hazard on the part of the sovereign. (b) Second, even with such a mechanism, the willingness of a debtor and its creditors to restructure will depend on the availability of financing to the member. Thus, the Fund will still have to judge whether the sustainability of a member's position warrants its financing, and if so, in what amount. To the extent that a legal framework does manage to reduce the cost of restructuring, however, members with unsustainable debt may be more willing to restructure, thereby reducing the pressure on the Fund to provide financing.

6. Because the establishment of the mechanism would require a major change in the existing international legal framework, such a mechanism could not be in place for at least several years.

7. While the introduction of such a mechanism would be helpful in resolving the problems of members with unsustainable debt positions, its absence does not mean that these problems cannot be resolved. Work on such a mechanism should be pursued in parallel with work on such matters as the analysis of debt sustainability, the facilitation of restructurings when needed, and appropriate access to the Fund's resources to help a member cope with capital account difficulties. These issues need to be addressed in the cases now in hand, as well as in a world containing a sovereign debt restructuring mechanism.

I. INTRODUCTION

Sovereign debtors facing severe liquidity difficulties often go to extraordinary lengths to avoid restructuring their indebtedness to foreign and domestic private creditors. A number of factors may have a bearing on this reluctance, beyond the psychological reluctance of governments to change strategy. First, there is the damage to the debtor's reputation and the associated impact on its ability to borrow again on acceptable terms. Second, a legal framework does not exist that would facilitate an orderly and rapid restructuring. Third, and perhaps most importantly, there is a concern that a restructuring may damage the domestic financial system, particularly when local financial institutions hold a significant portion of the sovereign debt. Finally, sovereigns may fear that, in the event that a restructuring becomes disorderly for all of the above reasons, the amount of financing required will increase and the Fund may not be in a position to meet this need.

A sovereign's reluctance to restructure places the official community in the uncomfortable position of either continuing to finance severe and nonsustainable imbalances, for possibly protracted periods, or cutting off support and forcing a sovereign that is otherwise cooperating in the implementation of policies to restructure its debt in a manner that, in the absence of an effective framework, could exacerbate its economic difficulties.

Finding a means of reducing the perceived costs of debt restructuring for sovereigns would facilitate the design and implementation of an effective strategy for involving the private sector in the resolution of crises. Clearly, the efficient operation of capital markets requires that restructuring should not become a measure of first resort. By the same token, however, when there is no feasible set of policies that can resolve the crisis in the absence of a restructuring, there is a need to find mechanisms that allow a sovereign seeking cooperative solutions to reprofile—and if necessary reduce—its debt burden, without being forced to bear excessive costs associated with a collapse of the domestic financial system, on the one hand, and disorderly creditor action, on the other.

This paper gives preliminary consideration to how modifications in the existing international legal framework could facilitate the orderly restructuring of sovereign debt and, thereby, reduce the cost of restructuring. It should be emphasized, however, that even the most effective legal framework will only address a subset of the most difficult issues in this area. Perhaps most importantly, it will not eliminate the severe economic dislocation that can arise as a result of a restructuring. Nor will it resolve the question of deciding when a member's indebtedness becomes unsustainable, thereby triggering the need for a restructuring. While these issues are not discussed in this paper, they are critical to any effective crisis resolution strategy.

II. THE PROBLEM

During the debt crises of the 1980s, the restructuring of sovereign indebtedness, although sometimes protracted, was generally orderly. Discussions between the sovereign and its

creditors generally took place within a collective framework, with the major creditors negotiating through a steering committee. During the negotiations, the committee performed a number of functions, including the resolution of inter-creditor problems, the assessment of the acceptability of the offers made by the sovereign, and the preservation of confidentiality. Moreover, to the extent that the major creditors formed part of the committee, the provision of new financing was facilitated by an agreement that any financing provided after a specified date would be excluded from any future restructuring. Finally, while creditors became less cooperative during the late 1980s, there was relatively little litigation during this period, notwithstanding the fact that sovereigns often found themselves in default for prolonged periods.

In retrospect, the orderliness of the process was attributable to the fact that the creditor body—being largely made up of commercial banks—had a number of incentives to cooperate in an orderly manner. First, they were interested in maintaining relatively good relations with the sovereign as a means of safeguarding future business. Second, they were subject to the suasion of their regulators and, therefore, the official sector. Third, because they had similar institutional and financial interests, inter-creditor problems were not overly problematic. Finally, the provisions of the legal instruments generally created a disincentive for rogue creditors to initiate litigation: the sharing provisions of the syndicated loan agreements would have required such creditors to share the proceeds of any recovery with other members of the syndicate.

As a result of the disintermediation that has occurred over the past 10 years, many of the incentives that previously gave rise to the orderly process described above no longer exist. First, in terms of their attitude towards the sovereign, investors that have purchased their claims on the secondary market often have no ongoing business relationship with the debtor and are not subject to suasion by the official sector. Second, the number and complexity of creditor claims has made creditor organization more complicated. This organization problem has been exacerbated by the repackaging of creditor claims in a manner that separates the interests between the primary lender (lender of record) and the end-investor (the beneficiaries holding the economic interest). Finally, experience has demonstrated that creditors have very diverse interests when they approach a restructuring. Bondholders with long-term interests that have purchased their claims on the primary market generally have an interest in a relatively rapid and orderly restructuring that will preserve the value of their claims. In contrast, creditors who specialize in obtaining settlement on favorable terms through litigation, benefit from the limitations of the current legal framework.

In terms of the restructuring incentives for both the sovereign and its creditors, a key issue is the likelihood and implications of creditor litigation. Although litigation against a sovereign to date has been relatively limited, evidence suggests that the prospect of such action is one of the reasons why sovereigns are reluctant to default or threaten a default. The gradual erosion of the doctrine of sovereign immunity and the practice of waivers has made the attachment of sovereign assets easier and, as was demonstrated in the recent legal action against Peru, it has also made the sovereign vulnerable to a form of blackmail: any creditors

holding out for full payment following a default can take legal action that may effectively preclude the sovereign from normalizing its relations with more cooperative creditors.[1]

The possibility of litigation also exacerbates inter-creditor difficulties. Clearly, not all creditors are prepared to sue a sovereign. Litigation is costly and many creditors will be concerned by the reputational damage of aggressive litigation tactics against a sovereign. Nevertheless, even those creditors that are more inclined to cooperate will find it more difficult if they feel that their forbearance will be abused by more aggressive creditors who will use litigation—or the threat thereof—as an effective means of extracting full payment. Moreover, in light of the litigation against Peru, potentially cooperative creditors will also be afraid that holdout creditors may use legal tactics to block any future payments that may be due to them under the restructured bonds.

As noted above, there is inadequate evidence to suggest that holdout creditors will always litigate or the extent to which the prospect of such litigation will invariably undermine the sovereign's ability to reach an agreement with the requisite majority of its creditors. Nevertheless, given the diversity of creditor interests and the absence of collective action clauses in all bond instruments (these clauses make a restructuring agreed by a majority of creditors binding on all other creditors in the same issuance), there is considerable uncertainty among all participants as to how the restructuring process will unfold. This uncertainty contributes to the considerable reluctance by the sovereign, its creditors and the official sector to pursue a restructuring, other than in the most extreme circumstances.

As a means of addressing the above uncertainties, the official community has made some efforts to promote the incorporation of collective action clauses into bond documentation. Notwithstanding the benefits of this strategy, it has a number of limitations. First, there is the transitional problem: a large portion of outstanding bonds with long maturities do not contain such provisions. Second, it is not a solution that the official community has the authority to impose. Whether such clauses will be included will depend on whether the sovereign perceives that they will be acceptable to creditors. As is evidenced by the terms of a number of recent bonds issues, sovereign debtors facing a crisis actually prefer to exclude such clauses as a way of demonstrating to creditors their firm commitment to pay on the original terms. (Ironically, the attention placed by the official community on the benefits of collective action clauses as an element in the private sector involvement strategy may have contributed to this dynamic.) Third, collective action clauses only bind holders of the same bond issuance and are of more limited use when a sovereign needs to engineer a broad restructuring that includes a large variety of instruments, including for example, private placements and commercial bank loans. Finally, and as will be discussed further below, such clauses do not

[1] In the case of Peru, a distressed debt purchaser successfully forced Peru to pay it the full face value of the debt by taking legal action that almost forced Peru to default on its obligations to its Brady bondholders.

address issues relating to the servicing of nonsovereign debt, which may need to be interrupted in the context of a financial crisis.

III. The Applicability of the Corporate Reorganization Model

When discussing the need for—and design of—a legal framework to address the above problem, some observers have drawn upon the analogy of the corporate reorganization provisions of a domestic bankruptcy law. As is discussed below, while this model can provide guidance in the sovereign context, there are important limits to its applicability.

A. The Model

When a financially distressed—but fundamentally viable—company finds that it can no longer service its debt, the company and its diverse creditors generally cannot turn to their domestic authorities for financing as a means of resolving this crisis. Rather, the legislation provides the necessary incentives for a debt restructuring agreement (that often involves substantial debt reduction) by establishing a court-administered reorganization chapter of an insolvency law. To the extent that the insolvency system is well-developed, most restructurings take place "in the shadow" of the law, i.e., without the need—and expense—of actually commencing formal court-administered proceedings.

The following core features of the law provide the key incentives:

- *First, upon commencement of the proceedings, a stay is imposed on all legal actions by creditors, thereby protecting the debtor from dismemberment.* The stay on legal enforcement is designed not only to protect the debtor, but also addresses the inter-creditor collective action problem. In the absence of a general stay on legal action, creditors would probably rush to enforce their claims out of a fear that others will also do so.

- *Second, during the proceedings, legal constraints are imposed upon the activities of the enterprise and a reorganization plan must normally be prepared within a specified time frame.* As a means of ensuring that the interests of creditors are protected during the reorganization proceedings, the debtor is precluded from entering into transactions that would prejudice creditors generally (e.g., transferring assets to insiders or making payments to favored creditors). To ensure compliance, the laws of some countries also provide for a court-appointed administrator to oversee the activities of the debtor during this period.

- *Third, as a means of encouraging new financing, credit provided to the debtor after the commencement of the proceeding must be given seniority over prior claims in any reorganization plan.* Normally, a creditor that has provided financing during the proceeding will have the right to be repaid once the reorganization plan is approved.

- *Fourth, a debt restructuring plan approved by the requisite majority of creditors will be binding on all creditors.* The law normally provides for the establishment of a committee of creditors that takes the lead in negotiating the terms of the debt restructuring plan with the debtor. To ensure that there is no fraud in the voting process, the court normally oversees the verification of creditor claims.

As noted above, a predictable system will enable the restructuring of corporate entities to take place in the shadow of the law. Such an out-of-court process generally mimics certain features of the formal process. For example, creditors agree to a voluntary standstill in the knowledge that, if they refuse, the debtor can make such a standstill mandatory by commencing formal proceedings. Similarly, during the out-of-court negotiations, potential holdout creditors realize that, if they are inflexible, the debtor and the majority creditors can use the law to bind them to the terms of the restructuring agreement. In sum, each party negotiates with a clear understanding of the type of leverage it□and the others□ would have if the formal system were activated.

B. The Limitations of the Model

As will be discussed in the next section, the above features are relevant to a discussion of the design of a sovereign debt restructuring mechanism. It should be noted, however, that the applicability of the corporate model is limited in a number of important respects.

- First, and perhaps most importantly, corporate reorganization provisions operate within the context of the potential liquidation of the debtor, which could not apply to a sovereign state. In the event that a reorganization plan does not attract adequate support from its creditors and the company continues to be in a state of illiquidity, most laws will provide for the automatic liquidation of the company. Moreover, the potential liquidation of the enterprise also shapes the terms of any restructuring proposal. Most modern laws provide that creditors cannot be forced to accept terms under a reorganization plan that would result in their receiving less than what they would have received in a liquidation.

- Second, since one of the purposes of a reorganization law is to enable creditors to maximize the value of their claims through the going concern value of the enterprise, most modern laws allow for the creditors to commence proceedings unilaterally so as to acquire the company through a reorganization plan that includes a debt-for-equity conversion that, in some cases, may extinguish all ownership interests of the incumbent shareholders. Again, such a feature could not be applied to a sovereign state.

- Finally, it is difficult to envisage how the constraints that are applied to the activities of a corporate debtor to safeguard the interests of creditors could be made legally

binding on a sovereign and enforced, particularly with respect to the exercise of its sovereign powers, including, for example, its fiscal powers.

In some respects, Chapter 9 of the United States Bankruptcy Code, which applies to municipalities, may be of greater relevance in the sovereign context. Although it includes a number of the core elements described in the previous section (the stay, priority for new financing and majority voting), it differs from the corporate model in a number of respects. For example, only the municipality (not its creditors) may commence proceedings and propose a reorganization plan. Moreover, the bankruptcy court may not interfere with any of the municipality's political or governmental powers, property or revenue or the municipality's use or enjoyment of any income-producing property. Finally, a Chapter 9 case cannot be converted into a liquidation case. Significantly, however, this proceeding does not impair the power of the state within which the municipality exists to continue to control the exercise of these powers, including expenditures. Clearly, a sovereign state is not subject to any similar controls.

IV. Assessing the Feasibility of a Sovereign Debt Restructuring Mechanism

A. General Objectives and Principles

Notwithstanding the limited applicability of the corporate reorganization model, a number of the benefits it provides could be of direct relevance in the sovereign context. Specifically, by providing a framework for the orderly and rapid restructuring of debt, a sovereign debt restructuring mechanism could help resolve creditor collective action problems in a manner that preserves value for the benefit of both the debtor and its creditors. Moreover, to the extent that the framework was applied with adequate predictability, it could facilitate the appropriate management and assessment of risk and, thereby, provide further stability to the international financial system.

A key objective of a sovereign debt restructuring mechanism would be to create the incentives for a sovereign debtor and its creditors to reach an appropriate debt restructuring agreement without having to rely on the actual use of the mechanism. This would require the rules governing the operation of the mechanism to be sufficiently clear and credible that the relevant parties were fully aware of the leverage they would possess if it were activated.

For the objectives to be achieved, and bearing in mind the relevance□but limited applicability□of the corporate reorganization model□what principles would guide the design and implementation of such a framework?

- *First, the mechanism would need to prevent creditors from taking action that would disrupt negotiations prior to a restructuring agreement.* The existence of a legally binding stay would make default less costly for the sovereign, thereby increasing the

credibility of a threat of default. It would also address the inter-creditor collective action problem.

- *Second, during the period of any stay on creditor action, the mechanism would need to provide creditors with some assurance that the sovereign was acting responsibly,* i.e., that it was adopting appropriate economic policies, negotiating in good faith so as to reach a rapid agreement, and refraining from taking specific measures that would prejudice creditor interests.

- *Third, it would need to be designed in a manner that facilitates the provision of new money by private creditors to help a member undertaking a comprehensive adjustment program to meet its financing needs.* This will require a mechanism for existing creditors (who stand to benefit from preserving asset values) to give those providing new money some degree of seniority. To the extent that such an inducement was successful, it could reduce the amount of financing needed from the official sector.

- *Fourth, to address the free rider problem, the mechanism would need to be able to bind minority creditors to a restructuring agreement that has been accepted by the requisite majority.* As in the corporate context, the terms of the restructuring would need to recognize that not all private creditors have the same rights vis-à-vis the debtor (e.g. secured vs. unsecured creditors).

The existence of the fourth element identified above would be critical for a number of reasons. First, unless holdout creditors can actually be bound to the terms of the agreement, they will merely enforce their claims once an agreement has been reached and the stay has been lifted. For this reason, a temporary stay will not, on its own, resolve the collective action problem. Second, by requiring that the agreement be approved by the requisite majority of creditors, creditors will have the assurance that the terms of the restructuring cannot be imposed upon them.

B. Incentives

If a sovereign debt restructuring mechanism were established along the lines of the above principles, what impact would it have on the overall economic and financial incentives of creditors and debtors? To what extent would these incentives be shaped by the role the Fund would play within this new framework?

Debtor incentives – While such a mechanism would reduce the costs of restructuring to the member, the effect would probably not be significant enough to overcome a sovereign's traditional reluctance to pursue a restructuring. On the one hand, the mechanism would reduce the costs resulting from litigation following any default and may speed up the restructuring process. Moreover, by enabling a debtor to reorganize its debts within a legal

framework that has been sanctioned as a matter of international public policy, the mechanism may tend to mitigate reputational damage. On the other hand, the mechanism may not, on its own, substantially reduce the disruption to the domestic economy. For example, a restructuring, no matter how orderly, may have a devastating impact on the banking system if domestic financial institutions hold a significant amount of sovereign debt, and if a restructuring triggers an unstoppable deposit run.

Accordingly, a member would weigh the cost of restructuring against the alternative costs of the adjustment needed to keep creditors engaged. As market conditions for the member deteriorate when a crisis looms, the amount of adjustment needed to restore confidence would also increase. Up to a point, this challenge may serve to galvanize the body politic to take the necessary measures, but at some point, the costs would be perceived to be greater than those of a restructuring. To the extent that the existence of a sovereign debt restructuring mechanism reduced the costs of restructuring, this cross-over point would occur earlier. However, this would also be apparent to markets, and thus the trajectory of the confidence loss will be steeper than in the absence of such a mechanism, and the timing of the approach by debtors to their creditors for a restructuring will be advanced.

Creditor incentives – Clearly, the establishment of the mechanism would not be viewed favorably by creditors if they thought it more likely that sovereign difficulties would be resolved through a restructuring rather than through additional large scale financing. If they accept that such financing is limited, however, and that workouts will in extreme cases be unavoidable, many creditors may favor a mechanism that is both orderly and predictable. This would facilitate the pricing and management of risk. Creditors with long-term commercial interests would presumably favor a mechanism that supports orderly adjustment and prevents a grab race, and thereby helps to preserve asset values. By the same token, investors who specialize in buying distressed debt in order to participate in workouts could benefit from the increased liquidity in the market associated with the greater predictability in the outcome. It is evident, however, that a minority of investors who specialize in extracting salvage value through litigation would oppose the mechanism. To the extent that the design of the mechanism included the core elements described in the previous section it would include a number of features that would serve to protect creditors' interests. In particular, creditors holding a large majority of principal would have leverage over both the terms of a restructuring and those dissidents creditors hoping to be able to obtain a more favorable settlement by refusing to participate in a restructuring.

For creditors holding claims on sovereigns, or contemplating the extension of new credit, the calculation would be whether the risk of loss on these claims continued to be adequately compensated; if it were, creditors would stay put or provide new financing; if it were not, they would leave, driving up the risk premium and reducing the flow to emerging market sovereigns. Creditors would assess that the likelihood of a restructuring will depend on the sovereign's current and prospective policies, and the amount of liquidity available to it. It is possible, however, for a given amount of liquidity, that there is no set of feasible policies that can avoid a restructuring. As the market makes this assessment, the cost of capital to the

country will rise, and along with it the arduousness of adjustment, precipitating the need to restructure under the mechanism.

The impact of the Fund on debtor-creditor incentives – The incentives guiding the behavior of the member and its creditors would be shaped significantly by the role played by the Fund in the implementation of the mechanism. In the corporate context, a debtor and its creditors resort to a reorganization framework because there is no source of additional liquidity that can be relied upon to avoid a restructuring. Accordingly, whether and on what terms financing is made available by the Fund prior to, during, and after the operation of the mechanism will determine whether it is used effectively by a sovereign and its creditors, or even used at all. Fund financing will alter the balance of the costs of adjustment and restructuring to the member, since this financing will help to keep creditors involved (or reduce the need to keep creditors involved), thus reducing the need for, or the cost of, adjustment. Indeed, there will be some amount of liquidity injection that would at least postpone the need for a restructuring. Thus, by being more or less generous in the provision of finance, the Fund can alter both the timing and the incidence of a restructuring under the framework. Moreover, to the extent that Fund financing during the post-stay period were limited, the member and the creditors would have a stronger incentive to reach a more durable agreement.

Thus, even if a sovereign debt restructuring mechanism were established along the lines discussed above, there is a risk that a sovereign and its creditors would collude to extract more assistance from the Fund, thereby undermining one of the key objectives of the mechanism, that of reducing moral hazard. In deciding whether to provide or withhold liquidity, the Fund would need to be guided by the principles laid down in the Articles. To the extent that a withholding of liquidity would create incentives for a debtor and its creditors to agree upon an orderly restructuring that creates a sustainable debt profile, the mechanism would assist the Fund achieve its purposes in at least two respects. First, by taking some of the strain off adjustment, it would enable balance of payments viability to be attained in a manner that minimizes the resort to measures that are destructive to national or international prosperity. Second, by limiting Fund exposure, it helps the Fund safeguard its resources. More generally, to the extent that an orderly debt restructuring forces creditors to bear the costs of the risks that they incur when they lend, it helps avert future crises and, more generally, provides greater stability to the international financial system.

At the same time, given the fact that a restructuring under the mechanism will still be relatively costly, the Fund would continue to be under pressure from the member to continue to provide financing so that an activation of the mechanism could be avoided, particularly in circumstances where the member is prepared to take very tough adjustment measures as an alternative to a restructuring.

In light of the above, therefore, a critical issue will be the formulation and application of the criteria that the Fund would use when making a judgment as to whether additional financing could be provided without the activation of the mechanism. Consistent with the emerging framework for private sector involvement, these criteria would need to relate to debt

sustainability and prospects for future market access, taking into consideration the degree of economic adjustment that can be credibly undertaken by the member. Access limits based on current quotas would not provide a satisfactory basis for determining whether a restructuring is necessary. There may be cases, for example, where a member seeking an exceptional level of financing (when calculated in terms of its quota) still has a sustainable debt burden and should not be forced to use the mechanism.

V. Specific Design Features

What would be the most critical issues that would need to be addressed when designing a sovereign debt restructuring mechanism that took into account the above principles and incentives? This section provides a preliminary discussion of these issues and, in that context, discusses in greater detail the role that the Fund would need to play to make the mechanism effective.

The Stay and Majority Restructuring Provisions

Any sovereign debt restructuring mechanism would need to be designed in such a manner to ensure that it creates adequate incentives for both the sovereign and a majority of its creditors to reach an early agreement on a debt restructuring that is consistent with the sovereign's debt service capacity. The design of the stay and the majority restructuring provisions would play a critical role in this regard.

Conditions for the activation and maintenance of the stay – A critical issue will be the effective trigger for the activation of the stay on creditor enforcement. One possible approach would be for the stay to be activated upon a request by the member that has been endorsed by the Fund. Applying the analysis contained in the previous section, the criteria that would guide the Fund's endorsement of the request could be a determination that: (i) even with effective implementation of policies, the member's debt burden is unsustainable and that there are limited prospects for future market access, and (ii) the member is implementing a Fund-supported program or is actively negotiating such a program. The requirement of Fund endorsement on the basis of the above criteria would ensure that members with strong fundamentals and, in particular, sustainable debt would be precluded from trying to shirk their financial obligations through the mechanism. As noted earlier, since many debtors would only seek activation of the stay if the Fund is no longer prepared to provide a level of financing that is sufficient to avoid a restructuring, the mechanism will only be used if it is accompanied by access policies that limit the availability of financing provided outside the mechanism in circumstances where the member's debt is no longer sustainable.

The maintenance of the stay on creditor enforcement would need to be conditional upon the existence of a number of safeguards. First, the sovereign would have to demonstrate that it was using the period of the stay to negotiate an appropriate restructuring agreement with its creditors and pursue policies that will enable it to resolve its external difficulties. Second, during the period of the stay, the sovereign would need to refrain from taking actions that

would prejudice the interests of creditors generally. Thus, for example, it would be precluded from making payments to favored private creditors during the period of the stay. Consistent with the approach followed in the corporate context, however, payments could be made to creditors that extended financing after the commencement of the stay.

It would be difficult to make a sovereign state subject to legal constraints on the operation of its economic policies. In certain respects, Fund conditionality would provide a useful means of ensuring that these safeguards are in place. To ensure adherence to the program, the Fund would endorse the stay for limited periods, which could be renewed upon the completion of the review under the relevant program (i.e., on a quarterly basis). Consistent with the Fund's existing lending into arrears strategy, completion of these reviews would also require a determination that the member was making progress in its negotiations with its creditors.

Notwithstanding the above, creditors may be concerned that a program would not provide them with adequate safeguards. For example, while a performance criterion on the minimum level of reserves may provide some assurances regarding the member's overall prospects, they may also insist that there be specific rules that preclude the sovereign from making payments to favored private creditors. Moreover, creditors may also insist that there be mechanisms to ensure that key assets are not dissipated, e.g., the establishment of monitored accounts that would receive the proceeds of any privatization. Such rules and mechanisms may need to apply in all cases and not be subject to vagaries of the design of specific programs. To create the necessary incentives for their observance, there would need to be some credible penalty for violation of these rules. The ultimate penalty would, of course, be the lifting of the stay and the withholding of Fund financing.

Maximum period of the stay – Since many of the creditors mark-to-market, they will have a strong interest in agreeing to a restructuring that takes place within a reasonable time frame. Moreover, and consistent with the approach followed in the corporate context, the establishment of a maximum period would place pressure on the sovereign to negotiate with its creditors in good faith. To avoid rigidity while, at the same time, maintaining the appropriate incentives, the mechanism could provide that a stay could not be extended beyond a specified period (e.g., 12 months) without the consent of the requisite majority of creditors.

The majority restructuring provision – As discussed earlier, for the mechanism to address the free rider problem effectively, it must include not only a stay but also a provision that enables a qualified majority to make the terms of a debt restructuring binding on all creditors. To ensure that the terms of the restructuring provide for a sustainable debt profile, some form of Fund endorsement of the terms of the restructuring would probably be necessary. Otherwise, there is a risk that the terms of the restructuring are such that an undue burden is placed on either the member's adjustment or future financing from the Fund.

Fund Financing

As discussed above, limits on the availability on Fund financing outside the mechanism in situations judged unsustainable would provide a necessary incentive for a member with unsustainable debt to request activation of the stay. Once the stay has been activated, the question arises as to what the role of Fund financing would be.

During the stay – Although a sovereign would receive substantial cash flow relief during a stay associated with a temporary suspension of payments to private creditors, there would likely continue to be a need for financing to ensure that the adjustment to the noninterest current account (plus interest to creditors that have been given priority under the mechanism) is orderly. Such financing could be provided under a Fund arrangement to enable the member to meet these specific financing needs.

After the restructuring – A restructuring would be expected to make a substantial contribution toward meeting the member's financing needs. It is clear, however, that the terms of the restructuring reached by creditors and debtors will, in part, reflect the expected scale of Fund financing in the period after the reorganization. This suggests that the scale and purposes of Fund financing may need to be limited to allowing the member to sustain orderly adjustment of the non-interest current account (plus debt service to preferred creditors) and to reconstitute reserves, rather than to finance payments to creditors on restructured debt. Although such financing would be limited, it would still provide indirect benefits to private creditors' confidence regarding the implementation of policies and the capacity to sustain payments under the restructuring agreement.

In the event of failure – Finally, the question arises as to what limits, if any, would be imposed on the availability of Fund financing if the stay is lifted prior to expiration (because of a lack of cooperation by the sovereign) or expires without a debt restructuring having been agreed to. On the one hand, as Fund financing is intended to promote orderly adjustment, it would appear to be inappropriate to provide financing to a member that is not cooperating in normalizing relations with creditors. Moreover, in the absence of such limitations, debtors and creditors will have little incentive to use the mechanism effectively once it is has been activated. On the other hand, the imposition of the penalty of the withholding of Fund financing in the event of failure will make it less likely that the parties will wish to activate it.

Scope of Debt to be Covered

Some of the most difficult issues that would need to be addressed would be the scope of debt that is subject to the stay and the majority restructuring provision.

Domestic debt – Would the debt that is subject to adjustment be limited to external debt (i.e., debt between residents and nonresidents and, perhaps, all other debt denominated in foreign exchange) or would it also include domestic debt? As has been discussed on earlier occasions, domestic debt may also need to be included for at least three reasons. First, as countries become more integrated into the global economy, the distinction between domestic

and external debt becomes progressively less meaningful for balance of payments purposes. Second, external creditors may be far less willing to agree to debt reduction if domestic creditors are to be paid in full. Third, a restructuring of the domestic debt may be necessary to ensure fiscal sustainability.

Nonsovereign debt – Would the debt covered be limited to liabilities of the sovereign (i.e., liabilities of the government and the central bank) or would it also cover those of other residents? This will depend on the origin of the financial crisis. First, even in circumstances where the external debt of the sovereign is not significant, a financial crisis can arise because of the overindebtedness of the banking and corporate sectors which, when coupled with a loss of creditor confidence, leads to a sudden depletion of foreign exchange reserves. Second, where a sovereign defaults on its own indebtedness, it is possible that such a default will trigger capital flight, particularly where the restructuring will embrace claims on the sovereign held by the domestic banking system, and if the member maintains an open capital account.

In exceptional cases, the authorities may choose to address these problems through the imposition of exchange controls. If the exchange controls were to interrupt the ability of residents to service their obligations to nonresidents, the question arises as to whether the stay element of the mechanism should protect the residents from legal action and, if so, how the stay should be applied. The application of the stay element to nonsovereign arrears would raise a number of difficult issues, including the relationship between the stay and the domestic insolvency law of the member and the adequacy of measures to protect creditor rights during the period of the stay.

Types of creditors – Would the mechanism apply to all creditors of the sovereign? For example, would the mechanism include persons or entities that are creditors as a result of the provision of services (e.g., government employees) or would it be limited to those creditors from whom the sovereign has actually borrowed money or received suppliers' credits. The latter approach would appear to be the more feasible.

A separate question relates to the coverage of official creditors. If the corporate reorganization model were to be followed, the only financing to be excluded from the restructuring exercise would be financing extended after the stay is imposed (e.g., stabilization financing provided by the Fund). This would mark a considerable departure from existing practice, where, for example, all bilateral official financing is subject to a separate rescheduling framework (the Paris Club).

Legal Basis for the Mechanism

Since the mechanism would affect the ability of creditors to enforce their claims in national courts (and, with respect to minority creditors, would adjust their claims without their consent), it would need to have the force of law in those countries where enforcement is sought. While this could be achieved, in part, by the adoption of domestic legislation in a number of key jurisdictions, such an approach would have a number of limitations. First, in

the event that these jurisdictions adopted such legislation, it is possible that creditors would ensure that future instruments enable them to enforce their claims in jurisdictions that have not adopted such legislation but whose money judgments are recognized in key jurisdictions under treaties or local law. Overriding the recognition of judgments would require either uniform recourse to the "public policy" exception to these general rules or an amendment of these rules. Second, such an approach would create its own "free rider" problem: countries would be reluctant to adopt legislation until they were assured that other countries have also done so. Third, there would be no assurance that all of the countries would adopt the identical text (moreover, interpretation may not be uniform if it is left to the decision of the courts in each country, which could lead to forum shopping by creditors).

A number of the above problems would be addressed by the adoption of a new treaty that was binding on all countries. However, the collective action problem identified above would only be addressed if it specifically provided that it would only come into force once all countries adopted it. Such a condition could *de facto* prevent the treaty from entering into force. In that context, one advantage of establishing these treaty obligations through an amendment of the Fund's Articles is that the international community could avail itself of the provision in the Articles (Article XXVIII) which provides that an amendment will become binding upon the entire membership once it is accepted by three-fifths of the members, having eighty-five percent of the total voting power.

Institutional Framework

Although the Fund's involvement in a sovereign debt restructuring mechanism would be critical to its success, it is not clear whether the Fund's existing institutional structure would equip it to implement other aspects of the framework. Since private creditors will be subject to the relevant provisions of the treaty, it is likely that there will be disputes between the sovereign and these creditors, as well as among creditors, the resolution of which will require rulings by an independent body. In addition, such an independent body will also be required to make a number of important decisions during the process, including, for, example, the verification of creditor claims and confirmation of the integrity of the voting process. Finally, since creditors do not always have the same rights (e.g., secured vs. unsecured claims) there may well be a need to classify creditors into different groups. In the corporate reorganization context, all of these functions are normally carried out by a court. The Fund's Executive Board would not be in a position to discharge these functions for a number of reasons. First, it would have neither the time nor the technical expertise to make decisions in this area. Second, there will be a concern regarding the Board's independence. Not only will the Fund be a creditor—with the power to provide additional financing in the future—but Executive Directors will also be representing the interests of Fund's shareholders, who are also creditors.

For all of the above reasons, it may be preferable for a new judicial or quasi-judicial organ to be established within the Fund that would have exclusive authority in these limited areas. This new organ would be staffed by persons that have proven expertise in this area and

would operate independently from management and the Executive Board. The Fund's Administrative Tribunal is an example of such a judicial organ.

In addition to resolving disputes and overseeing the voting process, the judicial organ could promulgate and monitor rules regarding the protection of individual creditor interests (payments to favored creditors, etc.). However, the judicial organ would not have authority to overrule decisions of the Executive Board relating to the implementation of the mechanism. For example, a decision by the Fund to endorse a member's request for the activation of the mechanism or to endorse the terms of a restructuring agreement could not be challenged by the judicial organ.

VI. AN ALTERNATIVE APPROACH

The introduction of a sovereign debt restructuring mechanism along the above lines would represent a significant modification of both the legal and institutional framework governing the operation of the international financial system. Notwithstanding the economic benefits such a mechanism could bring, there may be a general political reluctance among the membership to take such an ambitious step. Are there alternative—but more modest—approaches that would give effect to the general principles discussed in the previous sections?

Consideration could be given to an alternative framework that effectively relied upon the application of contractual provisions that a sovereign borrower would be *required* to include in all of its borrowing agreements. Drawing upon the majority restructuring provisions contained in many bond issuances, the terms of all borrowing agreements would provide that their terms could be modified pursuant to an affirmative vote of creditors holding a qualified majority (in terms of value) of the sovereign's entire indebtedness. To provide for a stay on creditor action prior to the reaching of an agreement (and consistent with the majority enforcement provisions contained in many bond issuances), the borrowing agreements could also be required to include provisions that would preclude creditors from pursuing legal action in the event of a default unless such action was sanctioned by the same majority of the sovereign's creditors. Finally, as a means of encouraging new financing, the agreements could be required to allow for a majority of creditors to agree that financing provided during the negotiations would be excluded from any restructuring.

By requiring the sovereign to include such provisions in all of its borrowing agreements, this alternative legal framework would address the existing reluctance for debtor and creditors to include them on a voluntary basis. At the same time, reliance on contractual provisions as a means to achieve an orderly restructuring could reduce the degree of official intervention in the mechanics of the restructuring process.

Notwithstanding the attractions of such a framework, there are a number of reasons why it would not be superior to the model discussed in the previous section.

First, while such a framework would address the problem of collective action among creditors (by enabling a majority of creditors to restrain the actions of a minority), it would not provide the debtor with any additional leverage during the restructuring process. Specifically, whether the sovereign would be protected by the stay would depend on the decision of the creditor group. Moreover, trying to obtain the requisite level of consent from a diverse group of creditors could present the debtor with considerable coordination problems and, more generally, would give rise to an environment of unpredictability during a crisis that would not exist if the stay were automatic, as discussed above.

Second, upon closer examination, such a framework would not necessarily be easier to either establish or implement. For example, so as to ensure uniformity of text and universal application, the legal basis for the framework would still need to be established by international treaty. Moreover, an international institution would still need to be charged with overseeing the integrity of the restructuring process. Most importantly, it would need to verify the true value of claims to guard against fraud in the voting process. In the absence of verification by an independent party, a debtor could, for example, inflate its debt stock significantly by establishing matching credit and debit positions with a related party. That entity—which could hold a qualified majority of all debt—could vote to reduce the value of all creditors' claims. While this could be mitigated by requiring a classification of creditor claims, an independent party would most probably be needed for this purpose. Finally, and perhaps most importantly, such a framework would not avoid the restructuring disincentives created by the existence of Fund financing. Indeed, it may exacerbate them: by making the stay entirely conditional upon creditor approval from the outset, this model will make default more risky for the sovereign when compared to the earlier model, thereby increasing the incentive for the sovereign to seek additional financing from the Fund as an alternative to a restructuring.

Finally, such an approach would not be able to address a number of the other issues that were discussed in the previous section. For example, , there is a transitional problem: while the approach discussed under the previous section could cover all existing long-term debt, the alternative model would only be applicable to debt issued after the treaty entered into force.