

**Improving the Sovereign Debt Restructuring Process:
Problems in Restructuring, Proposed Solutions,
and a Roadmap for Reform**

Nouriel Roubini
and
Brad Setser

Paper prepared for the conference on “Improving the Sovereign Debt Restructuring Process” co-hosted by the Institute for International Economics and Institut Français des Relations Internationales, Paris, March 9, 2003. We thank Fred Bergsten, Ted Truman, Bill Cline, Anna Gelper, and Jean Pisani-Ferry for useful comments and suggestions. The usual disclaimer applies with force: the opinions expressed in this paper are strictly those of the authors and not of any other institution or organization.

Nouriel Roubini
Stern School of Business
New York University
nroubini@stern.nyu.edu

Brad Setser
Council on Foreign Relations
bsetser@cfr.org

Introduction

The recent debate on reforming the international financial system has focused on the need to improve the sovereign debt restructuring process, and in particular on steps that could limit the risk that litigation could disrupt or delay a sovereign debt restructuring. This debate increasingly has focused on the debt restructuring process in those cases where debt reduction is needed to produce a sustainable debt profile. Less attention has been given to those cases where a sovereign lacks the reserves needed to cover its near-term obligations and, absent international support, has a clear need for debt rescheduling to push out near-term maturities.

There is a strong case for seeking to make the sovereign debt restructuring process more orderly, more predictable, and more rapid. There is also a strong case that steps to address collective action problems created by the threat of holdout litigation could help to improve the restructuring process, and give all parties more confidence that there is path that can lead a sovereign from the decision that a restructuring is necessary to its successful conclusion. Moreover, reasonable steps to reduce the risk of holdout litigation would not suddenly dilute the sovereign's incentives to pay: no rational sovereign would prefer default to payment just because it can restructure with a super-majority vote.

It is therefore important to capitalize on the enormous investment that the international community already has made in thinking through the problems that arise in a sovereign debt restructuring. It would be a shame if the debate that began with the G-10's report on Sovereign Liquidity Crises back in 1996 and that gained new prominence after the IMF proposed a new statutory bankruptcy regime did not ultimately result in the implementation of a series of concrete improvements in the sovereign debt restructuring process.

But it is also important to recognize that there are limitations to what likely can be achieved. The legal ability to bind in a minority alone will not significantly lessen the real economic costs of defaults or make it easy to turn down a country's request for official support. The case for taking steps to limit the risks of holdouts and to clarify the debt restructuring process with a code of conduct should rest on the ability of these steps to make the restructuring process more transparent and the outcome of the restructuring somewhat easier to predict *ex ante*—not on their ability to change dramatically the incentives facing either sovereign debtors or the official sector.

The first half of this paper is organized as follows: an initial section discusses the problems that arise when a sovereign needs to restructure its debts; the second section discusses the three main proposals that have been put forward to improve the sovereign debt restructuring process (clauses, codes, and statutes), emphasizing the differences between various contractual and statutory proposals as well as the difference between the contractual and statutory approaches; the third section synthesizes this discussion into four broad approaches to moving forward; the fourth section briefly lays out a set of recommended policy steps; and the fifth section suggests broadening the agenda beyond its current focus on steps to facilitate the restructuring of the sovereign's external debt in debt reduction cases. These five sections constitute a relatively short, self-contained paper that provides an overview of the issues that arise in a sovereign debt restructuring and potential solutions. The second half of the paper provides a more detailed

presentation of the case for the recommended set of policy steps, with analysis to help back up the judgments embodied in the proposed course of action.

Section I: Problems, Proposed Solutions, and a Roadmap for Reform

The problems that arise in a sovereign debt restructuring

Everyone—or at least almost everyone—can agree that the sovereign debt restructuring process should be improved. But agreement on the need for improvement masks different conceptions of the fundamental problems in the current sovereign debt restructuring process.

The **official sector** looks at the sovereign debt restructuring process and sees a process that is too “disorderly” and too costly to the debtor. In part, this is a lament by those in the official sector who must inevitably make difficult choices. A restructuring—which necessarily involves rewriting contracts to change their financial terms—will always be more complex and difficult to organize than the most obvious policy alternative: a bailout which allows a country to meet its contractual obligations, at least for a while. But there is also a sense that there is not a good enough map to guide a sovereign from the scary decision that it needs to restructure its debts to the successful conclusion of a restructuring. The lack of a good map, in turn, is one reason why sovereigns may wait too long to initiate a debt restructuring. There is also a sense that the existing process leaves the sovereign too vulnerable to the threat of litigation—whether immediately after default or after the conclusion of a restructuring.

Private creditors look at the existing restructuring process and tend to see a rather different set of problems. They see a process where there is no agreement—or rules—that outline how different creditor groups will be treated, and hence see a constant risk that a sovereign’s external creditors will be treated less well than other creditor groups. They also see a process where—official sector complaints about litigation to the contrary—it seems that creditors have far fewer legal rights than creditors of a bankrupt firm. There is no prospect that the creditors of a mismanaged sovereign will ever be able to change the sovereign’s “management.” They cannot even force a sovereign to put a restructuring proposal on the table within a defined time frame. They worry that any further steps to protect the sovereign from litigation would weaken the sovereign’s incentive to pay, and thus undermine the sovereign debt market. Many of the complaints of creditors also are a lament against the immutable realities of sovereign lending. A sovereign, unlike a firm, is never going to go away, and eventually should be able to pay something. But sovereignty also generates at least partial freedom from external legal authority.

Sovereign debtors look at the international financial system and see yet another set of problems. They worry that the official sector’s interest in developing a bankruptcy regime is primarily motivated by a desire to reduce the level of official support provided to debtor countries. Most want a global system that offers financial insurance against market turbulence that can result in potentially avoidable defaults far more than a global system that offers protection from litigation. Guillermo Ortiz memorably criticized the

official community for spending too much time trying to build morgues rather than constructing centers for preventive care. Emerging debtors know better than most that capital flows to emerging markets have already dried up and, like creditors, they worry that proposals to introduce new legal protections for debtors would further shrink the market for international sovereign debt. At the same time, many debtors—particularly those that have had to restructure their debts in the past—do see advantages in a process that would allow for more restructuring decisions to be taken by majority vote.

Rather than detailing all of the specific complaints that have been made, it makes more sense to step back and consider some of the basic problems that arise in a restructuring.¹ These include:

- *A rush to exit from the sovereign's own debt.* Creditors have good reason not to roll over claims on a sovereign that they believe will need to seek a restructuring in the near future. Indeed, creditors have an incentive—given all the inherent uncertainties associated with any debt restructuring process—not to roll over claims on an “illiquid” but still “solvent” sovereign. Indeed, the biggest cost associated with a run is a potentially avoidable default in a liquidity crisis. But it is worth remembering that a run on the sovereign's own debt is far less disorderly than say a run on a bank, or even a run on a fixed exchange rate. The maturity structure of the sovereign's debt tells creditors rather precisely where they stand in the queue—and gives some clues about how orderly the queue is likely to be. Those in the front of the queue may be able to get out before the sovereign runs out of either international reserves or loses the will to spend its remaining reserves to let those creditors at the front of the queue avoid any haircut. A larger stock of short-term debt increases the risk of a disorderly rush for the exits. Those holding long maturity claims are stuck. They can sell their claim to another creditor, but that transfers rather than extinguishes the claim. They do not benefit if a debtor spends its remaining reserves to pay short-term debts in a futile bid to avoid a restructuring. The Bank of Canada and Bank of England, among others, have noted that there is a simple solution to such a run—suspend payments on the sovereign's debt (or at least the sovereign's external debt), and then renegotiate the debt's terms. The new maturity structure stops the direct drain on the sovereign's reserves. But the admission that the sovereign cannot pay can itself trigger other types of runs.
- *A rush to the courthouse.* Suspending payments stops the drain on reserves associated with a rush to the exits, but without a formal stay on litigation or an informal agreement with its creditors, it also leaves the debtor open to risk of litigation. There is an advantage to being the first creditor to litigate—so long as the first creditor to litigate has the ability to successfully lay claim to the sovereign's few remaining assets. In practice, though, a “creditor grab race” has not proven to be much of a problem in the sovereign context. A bankrupt sovereign typically does not have many international assets to begin with, and the sovereign's international reserves and diplomatic property already enjoy

¹ See Nouriel Roubini, “Do We Need a New International Bankruptcy Regime? Comments on Bulow, Sachs and White”, April 4, 2002, and Nouriel Roubini, “Private Sector Involvement in Crisis Resolution and Mechanisms for Dealing with Sovereign Debt Problems, July 2002.

considerable protection from litigation. External creditors have neither the ability to lay claim on the sovereign's domestic assets nor the ability to go to court and force the sovereign to spend less and tax more to be able to pay more on its external debt. Creditors can litigate to make it difficult for a sovereign to "selectively default" on its external commercial debt, but cannot do much more. A sovereign cannot force its external creditors to give up their legal claims without their consent. At the same time, the sovereign's external creditors are not likely to recover much by litigating prior to a restructuring agreement, because of the considerable protection a sovereign already enjoys. Ultimately, external creditors need to agree to a restructuring to start receiving payments again.

- *Free riders or holdouts.* All creditors would be better off if they all agreed to restructuring that put the debtor back on a sustainable path, but each creditor individually would be better off if it got paid in full and other creditors agreed to the restructuring. Of course, not all creditors can hold out. If too many creditors hold out, there is no deal that makes sense for the sovereign. But if the number of creditors holding out is manageable (or if the legal risk posed by holdouts is judged to be low), the sovereign may opt to go ahead with the restructuring despite some holdouts. These holdouts can then sue for full payment, and seek to convince a court that the sovereign should not be allowed to pay its new debt so long as it is not fully honoring its old contractual commitment. This may give the holdout leverage to extract a favorable settlement. But holding out and litigating is costly and potentially risky strategy. Elliot's successful litigation hinged on an interpretation of the *pari passu* clause that may, or may not, survive further court rests. Most creditors are likely to conclude that the downside of holding an illiquid claim whose value depends on the courts exceeds the potential benefits of holding out. Moreover, the ability to amend the nonfinancial terms of even those bonds whose financial terms cannot be amended can significantly reduce the attractiveness of holding out. But without the ability to make a restructuring plan approved by a super-majority of creditors binding on a minority, there is no way to fully protect a sovereign from the risk of holdout litigation.
- *The absence of an enforceable priority structure for the sovereign's own debt that helps to settle questions of equity and the relative treatment of different creditor groups.*² A bankruptcy regime typically lets creditors know *ex ante* how they will be treated in relation to other creditors holding similar types of claims. Typically, all unsecured creditors are offered the same basic restructuring terms, because all unsecured debt has the same legal priority. The court can refuse to sanction any restructuring proposal that does not respect the existing rules of priority. In a sovereign debt restructuring, there are some informal rules of priority that are generally followed—it is hard for a sovereign that needs to reduce its debt to treat one bond issue better than another bond issue,³ and the IFIs are *de facto* given priority relative to other external claims. But there are no rules that determine how a sovereign should treat their unsecured domestic debt *vis a vis* their unsecured external debt, and the existing framework for

² Anna Gelper, "Building a Better Seating Chart for Sovereign Restructurings," January 21, 2003. Unpublished manuscript available from the author upon request.

³ Ecuador's Brady bond-holders refused to let Ecuador exempt its Eurobonds from its debt restructuring.

coordinating the restructuring of external private debt and external debt owed to other governments is under considerable strain. The absence of an agreed priority structure can make it difficult to reach agreement on a restructuring—the debtor and its creditors have to agree in broad terms on how different creditor groups should be treated before they can get down to negotiating financial terms. This is in no small measure one reason why it would take time to reach agreement on a restructuring even if the sovereign did not face the risk of holdouts. But the ability of the debtor to privilege some creditors without effective protest from others creditors also has some advantages. By paying the IFIs, trade creditors, and in some cases domestic debt, the sovereign can sustain access to some new financing even in the absence of any formal bankruptcy regime.

- *Policy conditionality.* There is an obvious need to coordinate the steps that creditors agree to take to make it easier for the debtor to pay with the steps that the debtor agrees to take to increase its ability to pay. This too poses challenges of collective action—after all, creditors are unlikely to have the exact same conception of what steps the debtor should take. It also can be a source of delay. Sovereign debtors in particular can have trouble adopting a coherent set of policies amid the economic and political chaos that follows a default. The current system for sovereign debt restructuring attempts to address this problem largely by linking the debtor’s program of policy reforms to new money (or the refinancing of existing exposure) from the IMF rather than by direct negotiation between the debtor and its external private creditors. External private creditors could refuse to restructure their own claims unless the debtor agrees to additional policy changes, but in practice this has rarely happened. Private creditors point out—correctly—that creditors play a much larger role in commercial debt reorganizations. But creditor demands for a larger role in the sovereign process are not matched by a willingness to increase their leverage by putting up new money, and there is no obvious solution to the inherent difficulties in coordinating the different demands for policy reform that come from disparate groups of private creditors.
- *Rush to default.* Sovereign borrowers worry that their creditors will rush to the exits at the first hint of trouble, precipitating an avoidable default. Private creditors worry that a sovereign will fail to honor its contractual commitment to pay, preferring an opportunistic default to necessary policy adjustments. Making restructuring too easy risks making default too likely, and therefore making credit for the sovereign too scarce. This risk has to be balanced against the gains from making it easier for a debtor that finds itself in a position where it cannot pay to reach agreement with its creditors on a restructuring that allows it to resume payments.
- *Other runs.* Stopping payments on the sovereign’s own debt eliminates a direct source of pressure on the sovereign’s reserves. But it may trigger other runs—a run on the domestic banking system, a run on the currency, and a withdrawal of cross-border bank credit. Domestic residents may seek to trade domestic bank deposits and other local financial assets for foreign bank accounts and foreign financial assets. However, if everyone wants out, in many cases, no one can get out. Prices go into free fall, markets break down, reserves are exhausted, banks

cannot meet their commitments to return deposits on demand and both bank deposits and currency markets end up frozen—at least temporarily.

There are obvious similarities between corporate bankruptcy and sovereign debt restructuring. But the analogy also has its limits. The absence of a formal bankruptcy process does create real complications for a sovereign debt restructuring—for example, a sovereign that reaches agreement with a large majority of its creditors still needs to worry about a few holdouts, while a firm does not. However, the absence of bankruptcy style protection poses less of a problem than one might think. Litigation immediately after default is less of a threat, as the IMF's most recent proposal for an SDRM has recognized. Delay (with continued protection from litigation) is costly, but it is always an alternative to a restructuring that leaves the sovereign too vulnerable to holdout litigation. The existence of the IMF, an international institution that links new money for the sovereign to policy conditionality, provides a means of providing new money in the absence of any established or enforceable system of priorities. It is also a substitute (creditors might argue an imperfect substitute) for court supervision of the debtor while the debtor is negotiating new payment terms with its creditors.

It is also important to remember that the sovereign debt restructuring process differs from corporate bankruptcy more because of intrinsic differences between a sovereign and a firm than because a sovereign lacks “bankruptcy” protection. No firm issues its own currency, or indirectly backstops the banking system.⁴ Sovereign debt is a typically a far more important asset in a country's financial system than the debt of even a very large local firm, and it plays a far more crucial role in the local financial system. There is no way to avoid the fact that a sovereign default is going to be more disruptive than the default of a firm. There may be room at the margins to improve on the existing sovereign debt restructuring process, but it is hard to change many of the basic realities that make sovereign default unpleasant.

The range of proposed solutions

No single proposal realistically could be expected to provide a comprehensive solution to the full range of problems that arise in a sovereign debt restructuring. Solving some problems may make other problems worse—offering the debtor too much protection after default may dilute the debtor's incentives to reach an agreement to resume payment, if not the debtor's incentives to take policy steps to avoid default. There are problems, like the holdout problem, that lend themselves to a legal solution, and problems which are unlikely to be ameliorated by legal change. Making it harder to litigate against the sovereign after it concludes a successful restructuring is not likely to change the behavior of either domestic bank depositors or cross border lenders immediately after a default. A sovereign that needs to reduce the value of its debt by half is not able to credibly protect bank depositors from the risk of losses, even in the unlikely event that the banking system itself does not hold much sovereign debt. Depositors run for a good reason.

⁴ See Allen, Rosenberg, Keller, Setser and Roubini, “A Balance Sheet Approach to Financial Crises”, IMF Working Paper 02/210, December 1, 2002, for a more complete discussion of balance sheet interlinkages.

Three general proposals have been put forward to solve some of the problems that arise in a sovereign debt restructuring: the introduction of **new contractual provisions** into new external debt contracts; the development of **a code of conduct** for a sovereign (and perhaps also its creditors) to follow during a debt restructuring; and the creation of a **new statutory regime** to provide bankruptcy-style protection for a sovereign. There are different variants within each option—both creditors and the official sector have put forward “contractual” proposals, and the IMF has put forward three different proposals for a statutory SDRM. The debate is not just clauses v. a statutory SDRM v. a code. It is also over what kind of clauses, what kind of SDRM and what kind of code.

Contractual proposals. All contractual proposals seek to change the restructuring process by changing the provisions found in sovereign debt contracts. Contractual change is best suited to either retarding a rush to the courthouse, or making it easier to address the holdout problems by allowing a supermajority to vote on restructuring terms. All contractual proposals would only have an impact if a large share of sovereign debt contracts contained the provisions; the existing \$200 billion plus stock of external law sovereign bonds is a constraint on the ability to any proposal to change the restructuring process immediately—for better or for worse.

There are four basic options that are implicitly on the table: using current New York law documentation in other jurisdictions; using current English law documentation in other jurisdictions; adopting the new clauses proposed by official groups like the G-10; and adopting the new clauses proposed by the “Group of Six” creditor organizations.⁵

- ***New York law documentation.*** A standard New York law contract requires the unanimous consent of all creditors to change “key financial terms”, which are defined narrowly as payment dates and amounts. All other terms typically can be amended with the support of one-half or two-thirds of the outstanding bondholders. Some but by no means all New York law bonds also require that 25 percent of the bondholders agree before litigation can be initiated—creating an effective litigation retardant.
- ***English law documentation.*** A standard English law contract allows a supermajority of bondholders (typically 75 percent) present at a meeting that meets quorum requirements to amend all the bond’s terms, including the bond’s payment dates and amounts. Many English law bonds also have provisions that make it more difficult for an individual bondholder to initiate litigation.
- ***The G-10’s draft clauses.*** The G-10 recommended following the English law convention and allowing a bond’s financial terms to be amended with a 75 percent vote. The G-10 also sought to broaden the use of trustees: a trustee provides a creditor representative that could facilitate communication between the debtor and its bondholders. Adoption of a trustee structure also would have the effect of making the decision to initiate judicial proceedings a collective decision.
- ***Group of Six clauses.*** Private creditors have proposed allowing 85 percent of bondholders to amend a bond’s financial terms, so long as no more than 10 percent of the bondholders object. That means it effectively takes 90 percent of

⁵ The provisions that Mexico introduced into its New York law bonds also have the potential to develop into a model for other issues. Mexico’s move came too late for its full implications to be assessed in this paper.

bondholders to overcome the opposition of 10 percent. The definition of financial terms would be expanded beyond payment dates and amounts, the remaining nonfinancial terms could be amended only with the support of 75 percent of the bondholders, and certain provisions that relate the ability of creditors to sue to collect on their bonds could not be amended at all. The debtor would have to meet additional financial disclosure requirements, and pay the expenses of a committee selected by creditors to represent their interests. In sum, provisions for amending financial terms would be tighter than the provisions now found in English law bonds, and provisions for amending nonfinancial terms would be tighter than the provisions now found in New York law bonds.

Deciding on the “right” set of clauses, however, is only part of the problem. The real challenge is convincing debtors to change the provisions used in their New York law bond issuance. There are a range of options, all of which are discussed in detail in the second half of the paper.

A code of conduct

A code of conduct cannot give the sovereign formal protection against litigation or the ability to restructure with a majority vote. No matter how much it might improve debtor behavior, a code cannot offer a definitive solution to the holdout problem. A code is better suited to addressing the other coordination problems that arise in a restructuring—coordination problems that stem fundamentally from the absence of an agreed system of priorities and the challenge of linking debt restructuring to policy change. Specifically, a restructuring requires:

- Coordinating the restructuring of an individual bond issue, i.e. limiting the risk that a minority will not go along with the restructuring of that bond’s terms.
- Coordinating the restructuring of different bond issues—something that is now typically done by an exchange offer.
- Coordinating the restructuring of external bonds with other types of sovereign debt. The Paris Club’s comparability requirement is one example of mechanisms to deal with this kind of coordination.
- Coordinating the debt restructuring with the changes in the debtor’s economic policies.
- Creditors also need to coordinate amongst themselves if they want to respond in a unified rather than disparate way to various proposals. The holders of a single bond can organize to represent the interests of that bond, the holders of all bonds can organize to represent the common interest of all bondholders, and all creditors with exposure to the sovereign can organize to represent the common interest of all creditors.

A code conceivably could lay out a roadmap describing how a debtor and its creditors should try to coordinate the restructuring of individual debt instruments so as to produce an overall change in the sovereign’s debt structure that restores sustainability. A code could lay out a set of general principles, or it could introduce detailed procedural

requirements that a debtor would need to meet to qualify for IMF lending. A code could lay out a process for restructuring a sovereign debtor's external private debt (largely bonds), or it could lay out a broader process for restructuring the debtor's overall debt stock and coordinating that restructuring with policy change. In sum, a code could be relatively modest, or it could seek to offer a comprehensive solution to many of the problems that arise in a debt restructuring.

No matter what the code aims to do, particular attention needs to be given to the set of incentives that will lead all parties to have an interest in abiding by a nonbinding code. A code could be designed to be self-enforcing—it could just lay out a set of minimal requirements that all parties should want to follow. Alternatively, a code could set out the requirements a debtor would need to meet to gain access to new money (presumably new money from the IMF, unless creditors are willing to commit new money to a debtor that abides by the code.)⁶ It is more difficult to see how a code could also much from creditors in the absence of a mechanism that lets creditors act collectively. Even if most creditors are willing to refrain from litigation if the debtor follows the code, these creditors cannot protect the debtor from a small set of creditors intent on litigating.

Existing proposals include:

- The Banque de France has suggested developing a code that would set out both general principles and best practices for meeting these general principles.⁷ The best practices could evolve in light of experience.
- The IIF has proposed a code which is long on requirements for the debtor and short on credible commitments by creditors. In effect, it is a very extensive code of debtor conduct to be enforced by IMF conditionality.
- Glenn Hubbard's call for a forum that would help a debtor contact its creditors, and help creditors organize to represent their interests in a restructuring.
- The IMF's lending into arrears policy can be considered a code of sorts. It links access to IMF financing to two general principles—"good faith" and "good policies"—and sets out some basic guidance on how "good faith" will be interpreted by the IMF.

A code of conduct potentially could help to facilitate a restructuring well before most bond contracts contain collective action clauses. Most proposals are not intended to substitute for efforts to introduce of new clauses into bond documentation.

⁶ In theory, adherence to the code during the restructuring could be a condition for creditors' final agreement on restructuring terms. However, this raises obvious problems of time consistency. If the debtor dithers for a few years before finally gets its act together and then puts forward an acceptable proposal, creditors are unlikely to turn the proposal down just to punish the debtor for failing to live up to a code immediately after its default.

⁷ Toward a Code of Good Conduct on Sovereign Debt Re-Negotiation, Issues paper prepared by Banque de France Staff, January 2003. The Banque de France's proposed principles include: early engagement with creditors; fair information sharing; fair representation of creditors; an expeditious and cooperative process; comparable treatment among creditors; fair burden sharing; negotiating in good faith; preserving the debtor's financial position; and restoring debt sustainability.

Statutory proposals

Like contractual proposals, statutory proposals primarily aim to address the “rush to the courthouse” problem and the holdout/ free rider problem, though the creation of a new statute creates at least the potential of solving other types of problems as well.

All statutory proposals offer two basic advantages over contractual proposals. First, a statutory regime would create the capacity to override existing sovereign debt contracts, and thus to immediately allow majority voting. There is no need to wait for the existing stock of roughly \$250 billion in sovereign debt governed by German and New York law to be retired. Second, a statutory regime would replace a process that requires amending the financial terms of each and every bond with a single aggregated vote by all bondholders on the debtor’s restructuring proposal. It is a lot harder to buy up a blocking position in the debtor’s entire debt stock than to buy a strong, and perhaps blocking, position in a single bond issue. Aggregated voting makes holding out much more difficult.

However, statutory proposals differ in other ways. The IMF has put forward three different proposals for addressing the “rush to the courthouse.”

- Anne Krueger’s November 2001 speech suggested giving the IMF the ability to provide a debtor with temporary legal protection.
- The March 2002 IMF proposal suggested allowing a super-majority of creditors to vote to determine whether or not to give the debtor legal protection. The IMF muddied up this proposal by suggesting that the IMF be able to protect the debtor while the creditor vote is being organized, but the basic logic of the proposal can best be understood as simply granting all authority to creditors.
- In January 2003, the IMF proposed dropping a stay altogether, and relying instead on the deterrent value of the ability to bind in holdouts and perhaps other litigation retardants.⁸ In its most pure form, this proposal would rely entirely on the protection national laws already provide a sovereign to deter litigation prior to a restructuring, and majority voting to avoid any holdouts.

Statutory proposals can differ in other ways as well. The scope of debt instruments that can be part of the binding vote on the restructuring proposal can be broad (including either Paris Club debt or domestic debt) or narrow (limited to external law debt held by commercial creditors). The debtor can have substantial freedom to select which particular instruments it wants to include in the restructuring plan, or it can be obligated to restructure all instruments that meet certain criteria. And finally, the protections of a statutory regime can be linked to a number of other debtor policies—including respecting a system of priority that might be designed to offer new money greater assurance of repayment—or the protections of a statutory regime can simply be made available to any debtor that can convince a majority of creditors to support its restructuring proposal.

Four additional points are worth emphasizing.

⁸ The “hotchpot rule.”

- First, there is no way to force a sovereign to make use of a statutory regime. The sovereign will always have the ability to opt to restructure its debts outside the statutory regime, using the “current” nonsystem. At least some creditors, in contrast, can be forced into the statutory regime against their will.
- Second, upfront legal protection after a default is not likely to radically transform the debt restructuring process, for the simple reason that sovereigns already enjoy considerable legal protection. Creditors are right—there has not been a rush to the courthouse in recent cases. Argentina’s experience is far from over, but so far litigation by external creditors has not been a major source of difficulty.
- Third, giving the IMF the power to impose a stay would transform the IMF’s role in the system more than it would transform the existing debt restructuring process, as the IMF would be able to link policy conditionality to legal protection as well as to the provision of new money.
- Fourth, not all statutory proposals are the same. At one extreme, a “light” statutory regime could generate a restructuring process that closely resembles the restructuring process found in existing English law clauses, but with aggregation and without the need to wait until the existing stock of New York law and German law bonds is retired. The IMF’s most recent proposal is in this vein. At the other extreme, a statutory regime could create a restructuring process that differs radically from the process that exists now. An ambitious statutory regime could try to draw in a wide range of different debts—including domestic debt—into a single framework, and condition IMF sanctioned legal protection on an extensive set of policy guidelines. Indeed, the policies a debtor would need to adopt to qualify for statutory protection could be set in advance to provide more “predictability”; they would not necessarily need to be left to the discretion of IMF staff and management.

The broad policy choices

Clauses, a code, and statutory change are not mutually exclusive options. A code of conduct could be combined with contractual change, or embedded in a statutory regime. But there are some combinations that make more sense than others. Indeed, there are really four broad options on the table.

- ***Live with the status quo.*** There is an existing debt restructuring process. It has its flaws, but at the end of the day, the current system allowed Ecuador to restructure its New York law bonds, Ukraine to restructure its English and German law bonds and Russia to restructure over \$28 billion in “London Club” loans into \$21 billion of new Eurobonds. In the near term, all contractual proposals will result in a restructuring process that is far closer to the existing process than to any idealized model, given the large stock of outstanding sovereign debt that will lack any contractual innovations.
- ***Majority restructuring clauses and a nonbinding code.*** The introduction of contractual changes that allow a majority of bond-holders to bind in a minority would gradually change the contractual terms in the existing debt stock. This would, over time, reduce the risks associated with holdout litigation and hopefully

make it somewhat easier for debtor to reach rapid agreement on restructuring terms with its creditors. Such clauses could be supported by a code that clarifies the existing debt restructuring process without imposing major new constraints on the debtor.

- ***The Group of Six's clauses and the IIF's code.*** Changes could be introduced into the existing process to give external private creditors increased leverage over a sovereign debtor. Contractual changes could limit the debtor's ability to amend nonfinancial terms, set high thresholds for amending financial terms, and force the debtor to finance the creation of creditors committees. A parallel code of conduct could set out major new requirements that a debtor would need to meet to gain access to IMF financing.
- ***A statutory SDRM.*** A new statutory regime could be created to give the debtor the advantages of a single aggregated vote on its restructuring plan. Access to this new statutory power could be linked to "a code of debtor conduct" embedded in the new statutory regime. An ambitious SDRM has the potential to radically change the current debt restructuring process.

Recommended next steps

Our analysis of the sources of difficulties in the current sovereign debt restructuring process lends support to the second broad option—clauses and a nonbinding code. The magnitude of the set of problems that can be solved by introducing a new legal regime is too small to justify imposing a radical new regime on reluctant creditors and debtors, with unknowable consequences. But there is scope to make improvements in the current system. And even modest improvements are unlikely to happen without impetus from the official sector.

We specifically recommend:

- ***Contracts.*** Build on the momentum created by Mexico's decision to introduce collective action clauses in its New York law bonds and strongly encourage other issuer to make majority amendment clauses the new norm in the US market. It is important not to gain the ability to amend the key financial terms of New York law bonds at very high thresholds—90 to 95 percent—by accepting other changes that would in practice make it easier to sue a sovereign or harder to restructure a bond (such as severe limitations on the ability of the debtor to amend nonfinancial terms). Change would no doubt be facilitated if US-based investors were willing to accept in principle what they already buy in practice—dollar denominated debt governed by English law with provisions that allow 75 percent of the outstanding principal to bind in a minority of 25 percent.⁹ If other New York law issuers do not follow Mexico's lead, the official should be prepared to go beyond jawboning to arm-twisting, and eventually to seek regulation or legislation that would require

⁹ US investors, by all accounts, have significant holdings of Russia's dollar denominated Eurobonds, all of which are governed by English law. English law bonds make up roughly 30 percent of the outstanding stock of international sovereign bonds, and dollar denominated bonds governed by English law make up around 20 percent of the EMBI index.

the use of clauses. This really does not require G-7 coordination, or changes in IMF policies. It does require a willingness on the part of US authorities to impose change on the market if those countries that typically issue in dollars using New York law do not move on their own.

- ***A code of conduct.*** Develop a nonbinding code that sets out a basic process for sovereign debt restructurings. This code should contain four core elements:
 - *New disclosure principles.* The debtor should be expected to provide full and accurate information about its debt profile and restructuring plans to its creditors. This should include publishing a full accounting (detailed and disaggregated) of its outstanding debts soon after defaulting, and informing creditors of any significant changes to its debt stock. At the time it is ready to put forward its initial restructuring proposal, the debtor should also provide, as in the IMF's most recent SDRM proposal, a list of claims that are being restructured through the exchange/ the initial restructuring proposal, a list of claims that are being restructured through other processes, and a list of claims that are not being restructured. It should also indicate how its overall restructuring proposal would apportion available near term cash flow across different creditor groups, and as well as how each creditor group is contributing to the creation of a viable medium term debt profile.
 - *An outline for how to move from imminent default to a successful restructuring.* Debtors will need to work with creditor representatives to develop a restructuring proposal. Creditors will need to organize themselves so that they can efficiently provide constructive input.¹⁰ Debtors should not be required to reach agreement with every member of the committee before launching an exchange—such a requirement could introduce a new source of delay into the existing process, without assuring that the exchange will attract broad based participation. Creditors will have the legal right to initiate litigation while the debtor is developing its restructuring proposal, though hopefully most creditors will refrain from litigating. Debtors are within their rights to seek to use their existing contractual powers—the ability to amend the financial terms of English law bonds, the ability to amend through exit consents the nonfinancial terms of New York law bonds—to limit the risks posed by holdouts.
 - *Realistic expectations about inter-creditor equity.* It would facilitate agreement if external creditors would recognize that external and domestic debt is unlikely to be restructured on the same terms. Perfect equity may not even be in the interest of external creditors: a domestic debt restructuring that triggers a bank run that could ultimately result in lower recovery levels for external creditors. At the same time, debtors should not expect that domestic debt can be entirely left out of any restructuring. In many cases, both domestic debt and external debt will need to be restructured. But domestic debt and external debt are likely to be

¹⁰ In relatively simple cases (limited number of instruments, rescheduling rather than debt reduction), the debtor may be able to rely on informal markets soundings. In more complex cases, the debtor may need to work with different committees rather than one single committee.

restructured at different times, using different restructuring processes and on different terms. Absent ex ante consensus on what is a “fair” allocation between domestic and external creditors, little is gained from promising too much. A code should not do more than insist that the debtor lay out its plans for all to see and assess.

- *Clauses in new bonds.* There should be an expectation that the bonds that emerge from the restructuring will contain clauses that allow the amendment of the bond’s financial terms.
- ***The SDRM.*** Accept that there is not currently the political consensus needed to create a statutory SDRM by amending the IMF’s Articles. But it is still worth seeking broad G-7 and G-20 consensus on what any future statutory regime should aim to do. Key questions that have not been resolved include: Is there a need for a stay on litigation, or does the prospect of being bound in by a super-majority vote at the time of the restructuring suffice to restrain a litigious minority? Is there a need to give legal priority to new private money, or should the IMF/ MDBs remain the only sources of “debtor in possession” financing in the system? What role should the IMF play in determining whether a country should have access to the protections of an international bankruptcy regime? This means stepping back from the current push to reach quick agreement on a detailed, operational design.¹¹

We have no illusions about what can be achieved by these proposals. A code of conduct combined with the gradual introduction of collective action clauses will not suddenly make a sovereign debt restructuring fast, painless or easy. Such changes offer no guarantees that debtors will decide to seek necessary restructurings more quickly. Indeed, it is doubtful that debtors delay right now primarily because some existing bond documentation fails to provide for a majority vote to amend key financial terms. Steps to lay out a more defined and transparent process for debt restructuring—even if buttressed with clauses—will not make it substantially easier for the international community to deny a country access to large scale emergency financing at early stages of a crisis. The immediate costs of initiating a restructuring will always be higher than the immediate costs of providing a country with time to see if it can avoid a restructuring with large scale financing. A more transparent restructuring process does not even guarantee more rapid agreement on restructuring terms.

These proposals will strengthen, not replace, the existing process for sovereign debt restructuring. In the near term, most bonds will lack clauses allowing the amendment of financial terms. Debtors with outstanding New York law bonds will need to rely on the second best solution of amending the bonds’ nonfinancial terms (through exit consents) to make holding out less attractive. Debtors also will need to continue to use multi-instrument exchange offers to coordinate the restructuring of different bond instruments. Such exchanges lack the elegance of a single aggregated vote, but do allow

¹¹ The detailed proposal that the IMF put forward in January provides already provides a decent starting point for further work, should a consensus to move forward ultimately develop. But the pain associated with negotiating final agreement on the details of a draft treaty that lays out a comprehensive design for a statutory SDRM is not worth the marginal gain, given the low probability that a treaty will be adopted in the near future.

the debtor to know the number of holders of each bond who have accepted its proposal (and thus the size of any holdout problem) before it decides whether or not to go forward with the exchange. There are limits to what the IMF can be expected to impose on debtors through its lending into arrears policy—the IMF must balance a series of different objectives after a default and will not focus its conditionality exclusively on enforcing an extensive code of conduct. A more modest code that focuses on making the existing process more transparent is therefore likely to be more robust than a more ambitious code that aims to do more than is possible.

Broadening the work program

Finally, it is important to broaden the official sector's work program beyond the current focus on limiting the risks of litigation in debt reduction cases. There are a range of problems in the international financial architecture that fundamentally do not stem from the risk of litigation in those cases where a sovereign needs to reduce the value of its debt. There is no doubt a long list of such problems. But our short list would include:

- *How best to handle those cases where the country confronts an immediate shortage of liquidity that stems in part by fears about the country's future solvency?* The easiest answer is to provide the needed liquidity through large scale official financing and to link the financing to policy adjustments to address fears about solvency. If the country's short-term needs for liquidity are large and the risks to its solvency are great, this implies official sector must assume large risks. There is a risk that the upfront liquidity supplied by the official sector may not be matched by the sustained adjustment needed for solvency. There is also the risk that the official sector will base its financing on overly optimistic assumptions about future market access, and the agreed combination of financing and adjustment will not result in private financing on a scale that allows quick repayment of the official sector or on terms that are consistent with the country's ultimate solvency.¹² Since there will be cases where the risk of lending to a potentially insolvent country will preclude the provision of sufficient official financing to address the country's immediate liquidity problems, it would be worthwhile to work seriously to develop a broader set of approaches for those cases that fall in the messy middle between pure illiquidity and pure insolvency. The option of using of more limited amounts of official financing to support countries that are pursuing targeted debt restructurings that aim to extend maturities at a reasonable cost should be put squarely on the table.¹³
- *How best to handle nonsovereign balance of payment crises?* The current focus on sovereign debt restructuring is hard to square with the difficulties

¹² "Failed" large packages—like the packages granted to Argentina and Russia—may help to limit the risk of moral hazard. The official sector clearly does not provide enough financing to protect creditors from all losses. But "failed" large packages that exhaust the country's capacity to borrow from the IFIs in an unsuccessful attempt to avoid default unquestionably do leave the official sector with fewer available tools to help mitigate the pain associated with an eventual restructuring.

¹³ The Banque de France usefully includes a scenario where debt renegotiation helps to alleviate tensions "on a sustainable debt" in its discussion of a code of good conduct.

that Asian emerging markets experienced with nonsovereign debt. The sovereign's external debt usually has a longer maturity structure than the private sector's external debt, in part because emerging market sovereigns typically raise external funds by issuing long-term bonds while banks and firms often rely more on short-term cross-border bank lending. The fall in cross border bank exposure in Korea, Turkey, and most likely in Brazil last year, was faster than the fall in the stock of external bonds outstanding.¹⁴

- *Are there ways to restructure the sovereign's debt without triggering a banking crisis?* And, when a restructuring of the sovereign's liabilities also requires a restructuring of the banking sector's liabilities, what is the best way of allocate unavoidable losses among the bank's equity investors, the bank's local depositors and external banks with cross border exposure? Domestic banks, not external bondholders, are the largest creditors of most of the world's most indebted emerging market economies. In some cases, it may be possible to insulate the banking system from the impact of a sovereign default and restructuring. But it is hard to see how the debt relief some countries would need if they had to seek a restructuring could come exclusively from external bondholders. Standard bank restructuring techniques offer little useful advice—standard banking crisis management is all about avoiding the need to restructure bank liabilities by using the strength of the sovereign's balance sheet to protect depositors from losses, not how to pass the losses on the banking system's sovereign lending onto bank depositors.
- *Are there creative ways to limit the risk that a sovereign debt crisis will also turn into a currency crisis, and the risk that a currency crisis will trigger a sovereign debt crisis?* The decision to seek a restructuring can trigger a run on the currency and a rush to sell all liquid domestic financial assets. The large real depreciation in turn impacts on the balance sheet of local residents who have borrowed in foreign currency. A currency crisis—particularly if there is severe overshooting—can also trigger a sovereign debt crisis if the sovereign has large foreign currency debts. Options for limiting this risk include a greater willingness to provide new official financing in the context of a restructuring, and a greater willingness to sanction targeted exchange and currency controls—including selective standstills on some types of external payments
- *How to unwind large scale IMF lending in those cases where the country simply not in a position to be able to repay the IMF as quickly as promised?* After default, the speed with which the IMF reduces its exposure will have a major impact on the cash available to be “spent” on the resumption of payments on private debt, or other “goods.”

¹⁴ JP Morgan estimates that during the course of 2002, Brazil's public sector external debt increased from \$93.2 billion to \$123.0 billion, in part because of IMF borrowing, and Brazil's private sector external debt fell from \$116.7 billion to \$90.7 billion. Turkey shows a similar pattern, from 2000 to 2002, public sector external debt increased from \$63.9 billion to \$83.5 billion, while private sector debt fell from \$55.8 billion to \$45.0 billion.

Section II. An Agenda for Reform

This section of the paper provides a more complete rationale for the proposals put forward in the first half of the paper.

The analysis is informed by the description of the problems that arise in a debt restructuring that laid out at the beginning of the paper. It is also informed by a sense of what is achievable. There is agreement on the need to improve the sovereign debt restructuring process—and consensus at least within the official sector that steps to limit the risk of holdout litigation could play a role in catalyzing that improvement. But there is little prospect of developing an international consensus on many other major issues in the near term.

- There is not agreement on when a sovereign debt restructuring, or indeed any form of debt restructuring, is the right response to a balance of payments crisis. Some believe debt restructuring should be reserved for only those cases where debt is unsustainable, others believe that some form of restructuring is an option when financing needs are large but the overall debt is sustainable (i.e. there is a liquidity problem). It is easier to agree on how a country should restructure its debt than to agree on when a sovereign should restructure its debt.
- There is not agreement on the right level of IMF assistance. The G-7 has consistently expressed its desire for a tougher, more restrictive access policy. The G-7, and others, also have consistently supported giving exceptional access to most large emerging market economies and a few small emerging economies as well. Exceptional is the norm for major emerging economies in trouble. But there is no desire to harmonize rhetoric with reality—adjusting the rhetoric to match the reality of large packages has its costs; cutting back the level of access to match the rhetoric also has its costs. It is easier to live with inconsistency.
- There is not agreement on the need to act now to create a SDRM. No matter how clever the design proposed by the IMF, the broad-based political will needed to impose an unwanted statutory regime on issuers and investors does not currently exist. This all may change if Argentina experiences difficulties with holdouts—after all, a complex multi-instrument restructuring is precisely the kind of case where a SDRM should be most useful. But there is no willingness to fight a preemptive war to “liberate” Latin America—and perhaps others—from the threat of rogue creditors.

There is still scope to move forward, however, if one accepts that the impact of any change is likely to be rather modest in the near term. The dual-track approach should not mean more analytic work on both the statutory and contractual approaches and concrete action on neither. Contractual changes should be introduced to make it harder for individual creditors to holdout and litigate after a restructuring deal has been completed. A code could try to set out a framework that makes the sovereign debt restructuring process more transparent. US Under Secretary Taylor was right last April: the time for action is now.

The contractual approach

The bottom line: Market participants currently do not see holdout litigation as a major threat to their interests. If the official sector believes that it is important for systemic reasons to change documentation to make holdout litigation more difficult and market participants do not share a similar concern, the official sector cannot realistically expect such change to emerge spontaneously from the market. Either sovereign debtors will have to insist on such provisions in their new issues, or official action will be needed to achieve the official sector's goals. Mexico's decision to take the lead and to issue a New York law bond with provisions that allow amendment of its financial terms should be followed by a serious effort to convince other debtors to follow Mexico's example. If this does not work, and additional arm twisting also fails, a serious effort to change SEC regulation is needed.

The challenge is actually quite simple: changing market practice in bonds governed by New York law.

Bonds governed by English law typically allow a qualified majority to amend key financial terms. One major emerging market economy (Russia) traditionally has used English law for its dollar-denominated bonds, and a second major issuer (Mexico) just announced that it would introduce English style provisions into its new New York law bonds. A wide range of issuers—including a few Latin countries that were major issuers until a few years ago—use English law for their Euro-denominated issues.¹⁵

English law documentation is also accepted by investors in the secondary market—consider the popularity of Russia's Eurobonds. Indeed, any US fund manager that avoided those dollar-denominated bonds that have clauses in 2001 and 2002 would almost certainly be out of job by now. In the market for dollar bonds, going “underweight” bonds with clauses meant going underweight star performers Russia and Ukraine and going overweight Argentina and Brazil.¹⁶ It remains to be seen how the market will react to Mexico's initiative.

However, investor groups have shown far more enthusiasm for contractual changes that would make bonds more difficult to restructure than for changes that would make it easier to avoid holdout litigation.¹⁷ Issuers that traditionally have not used English law also have been reluctant to change their issuance pattern. Prior to Mexico's

¹⁵ Issuers only use a few jurisdictions for international bond issuance. New York is by far the most important jurisdiction, with England in second place. German law bonds traditionally have also lacked clauses, but German law is being used less in new issuance following the introduction of the Euro.

Nonetheless, Germany should be willing to take the steps needed to change market practice in Germany.

¹⁶ In a J.P. Morgan investor surveys during the month of February have consistently shown that Russia is the biggest “overweight” and that Lebanon is the biggest “underweight.” Russia is unusual because it uses English law for its dollar bonds; Lebanon is unusual because it uses New York law for even its Euro denominated bonds. Investors, wisely, don't believe New York law alone offers that much protection against default. For a recent survey, see J.P. Morgan Emerging Market Research, *Emerging Markets Today*, February 27, 2003, p. 14.

¹⁷ Investor groups initially proposed a significant tightening of provisions that allow the amendment of non financial terms in return for provisions that would require the support of 95 percent of the bond's holders to amend the bond's financial terms – changes that would make a debt restructuring substantially more difficult, not easier. They subsequently have suggested allowing no more than 10 percent of a bond to be bound against its will, but only in conjunction with a series of other changes that would give creditors much more leverage over the restructuring process.

decision, those emerging markets that typically issue dollar bonds governed by New York law were reluctant to change the documentation they use in New York or to shift their dollar issuance to London—presumably because of fears that any change would be perceived as signaling a reduced commitment to pay.¹⁸

Movement on clauses ultimately requires two things: agreement on a set of changes to the documentation “boilerplate” that is now used in most New York law bonds, and willingness on the part of issuers to insist—despite the resistance that will come from some in the market—that the new documentation be used in their New York law bonds. Both the G-10 and a group of six organizations representing private sector investors have been working on a set of draft clauses. But the challenge of deciding on a reasonable set of clauses is ultimately not that complex a problem.

- There is little need to deviate from the template used in English law bonds. Bonds governed by English law are widely accepted by the market. English law bonds make up 20 percent of the EMBI and a higher percentage of the less important Euro denominated indexes. There is little reason to believe that moving to English style documentation would kill the market, or lead flows to dry up. No one seriously doubts Russia’s market access right now—and Russia traditionally has used English law for its dollar bonds.
- There is no evidence that the use of English governing law provisions changes an issuer’s incentives to pay, or that issuers discriminate against bonds that contain clauses in a multi-instrument restructuring. It is not necessary to offset the introduction of majority amendment provisions with other provisions to strengthen the debtor’s incentive to pay, because there is no evidence that English style clauses dilute a debtor’s incentive to pay. Rather, the evidence to date strongly suggests that governing law does not drive decisions about which bonds to restructure. Ecuador defaulted on its New York law Brady/ Eurobonds. Russia opted to exclude its English law Eurobonds from its restructuring. Argentina’s bonds governed by New York law have not been treated better—or worse—than Argentina’s English law bonds. Ukraine offered English law bonds with clauses and German law bonds without clauses the same basic restructuring terms – it exchanged old bonds for new bonds at par, with cash settlement of accrued interest.
- There is room to make some small changes to English law documentation. Restructuring a bond’s financial terms with a vote of 75 percent of the bond’s outstanding face, not 75 percent of those who show up at a meeting, provides investors with a degree of protection without significantly compromising a debtor’s ability to make use of these provisions. There also are the advantages to being able to amend the bonds with a written vote; it is cumbersome to have to call a formal meeting after a successful exchange offer.
- There is a case for excluding bonds held directly by government/ central bank from the vote. It is also worth thinking through those cases where the domestic banking system holds large quantities of the sovereign’s international bonds (Lebanon, Turkey). If bonds held directly by the central bank and the government

¹⁸ Egypt did issue a New York law bond with majority amendment provisions in 2001 – a change that seemed to go under the radar screen.

are excluded, it also makes sense to exclude those bonds held by banks that have been formally intervened and taken over by the government. But bonds held by regulated domestic banks that have not been closed down should be allowed to vote. The additional protection excluding these bonds would provide international investors is not worth the risk to the domestic financial system that would be created if a minority of international investors could determine the restructuring terms of bonds held primarily by the domestic bank system.

- It is vital for debtors that a majority of creditors be able to rescind the acceleration of a bond, and it helps if exit consents can amend the bond's nonfinancial terms to gut the ability of holdouts to reaccelerate the bond. This increases the cost and reduces the gains from holdout litigation.¹⁹
- Poison pill clauses that allow amendment of a bond's financial terms at high thresholds (90 to 95 percent) in exchange for a host of changes that make it more difficult to amend nonfinancial terms and otherwise make restructurings more difficult²⁰ will not achieve the official sector's core objective of making it easier for the debtor to avoid holdout litigation. Certain creditor concerns can be accommodated, but the overall package should clearly make it easier than it is now, not harder, for the debtor to deal with holdouts.
- 90 percent majority action (or 85 percent unless 10 percent objects, which effectively is 90 percent) sets too low a threshold for a typical emerging market bond. Many new bonds are issued in denominations of \$500 million, and relatively few new issues are larger than \$1 billion. With 90 percent majority action, a creditor needs to purchase \$50 million face to block any amendment of a \$500 million bond. If the bond trades at 20 cents on the dollar, that only requires a \$10 million investment. Elliot, it is worth recalling, spent around \$11.4 million to buy around \$20 million (principal value) in debt, and ultimately settled for around \$58 million (principal, interest arrears, and legal fees).²¹ Consequently, 90 percent majority action does not offer the debtor much practical protection against smart, motivated holdouts—particularly for relatively small bond issues. In most circumstances, debtors would be able to defend themselves against holdouts more effectively with the current New York law documentation, which defines nonfinancial terms broadly and gives the debtor the right to amend nonfinancial terms with the support of 2/3s of the bondholders.²²

¹⁹ The ability to deaccelerate only helps if the bond has a relatively long residual maturity; i.e. they helped Ecuador, but would not have helped Ukraine. Potential holdouts in Argentina therefore have an incentive to cluster in bonds that have short residual maturity, and that lack clauses.

²⁰ The “Group of Six” (the IIF, EMTA, EMCA, IPMA, SIA, BMA) has proposed a tightening of provisions allowing the amendment of non-financial terms in exchange for provisions that allow the amendment of a bond's financial terms with the support of 90 percent (down from 95 percent) of the bond's creditors.

²¹ Litigation is expensive, so holdout litigation makes financial sense only if the potential holdout has been able to obtain at a low cost a position that is large enough to create a return that justifies the risks of litigation. Financial details on Elliot Associates litigation against Peru are from Moody's Investors Service, “How to Sue a Sovereign: The Case of Peru”, November 2000.

²² Of course debtors would be worse off if the work of the “Group of Six” (the IIF, EMTA, EMCA, IPMA, SIA, BMA) resulted in a tightening of provisions allowing the amendment of non-financial terms without any change in provisions that currently prohibit the amendment of financial terms.

- However, there is room to make it more difficult to make use of provisions to amend nonfinancial terms **in the context of a broader package** that clearly give the debtor a real prospect of avoiding holdouts by amending the bonds' financial terms. Should bonds contain clauses that allow the debtor to amend the bond's financial terms over the objections of a minority of 24 percent, or even 19 percent, it is reasonable to expect that the debtor would rely on these provisions—not the provisions that allow the amendment of nonfinancial terms—to assure broad participation in the restructuring. For example, Mexico's new bond both defines financial terms more broadly than has been typical in New York law bonds and contains new provisions that allow 75 percent of the bond-holders to change the bond's key terms.

The hard part is not developing a template for contractual provisions that would give issuers more leverage over holdouts—typical English law provisions, the G-10's proposals and the documentation Mexico used in its new bond issuance would all work. The hard part is creating incentives that will lead issuers to introduce such provisions into their New York law bonds. Prior to Mexico's bold decision, issuers worried that *initiating* a change in their bond documentation would be perceived as signaling a reduced commitment to pay and would complicate their ability to market their bonds. Debtors traditionally have not attached a high value to terms that would only help if they were to default.

Obviously, investor acceptance of any change in documentation would be helpful. But debtors and the official sector needs to recognize that the market may not be willing to “voluntarily” endorse provisions that further the official sector objective of making it easier for the debtor to deal with holdouts, given the low priority that the market places on the risks posed by holdouts. There is no evidence that suggests that debtors are more likely to default on a bond just because the bond has clauses. It is extremely unlikely that a debtor that has both bonds with clauses and bonds without clauses would be able to discriminate against the bonds with clauses in a restructuring—a majority of holders of the bond with clauses would not accept anything less than equal treatment. But, to be honest, there is not enough experience to determine conclusively whether investors would be hurt or helped if *all* the debtor's bonds had documentation that reduced the risk of holdouts. On one hand, the need to attract the support of 95 percent rather than the support of 75 percent of creditors may lead the debtor to make a more generous restructuring proposal than it otherwise would. On the other hand, the majority of investors potentially suffers if a debtor would do a deal that is acceptable to three-quarters or four-fifths of its creditors, but is not willing (or able) to do a more expensive deal that attracts the support of 95 percent of its creditors. And the cash that ultimately is used to pay holdouts in full is cash that potentially could have sweetened the broader deal. At the end of the day, there is nowhere near enough evidence to make firm judgments.

Documentation proposals from market participants certainly seem to be motivated more by a sense that creditor's legal rights following a default need to be strengthened than by a sense that it is in the interest of creditors to make it significantly easier for a debtor to avoid holdouts. Market participants note that holdouts have not blocked any

recent deals, and tend to assume that the incremental costs associated with settling the claims of holdouts are born by the debtor.

But if investors do not want English law style clauses as ardently as the official sector, it is up to industrial country authorities either to develop a package of carrots and sticks that leads issuers to conclude that such clauses are in their own interest or to require their use. To put it somewhat undiplomatically: investment bankers love fees more than they hate clauses, and emerging market fund managers fear managing a portfolio of low yielding, risk-free bonds far more than that they fear managing a portfolio of emerging market bonds with collective action clause.

What concrete steps could be done to build on Mexico's leadership and prompt generalized change in New York law practice?

- Other issuers should be encouraged to follow Mexico's lead. Mexico has traditionally been a pioneer in the market. And if Mexico continues to issue bonds with clause and Russia continues to use English law for its sovereign bonds, clauses will soon constitute a major share of the EMBI. That share would only go up if Argentina uses Mexican style clauses in its new bonds. The standard documentation could change quickly. Both Mexico and its investment banks (JPMorgan and Goldman Sachs) deserve to be commended for their willingness to seize the initiative. Issuers that continue to use the old boilerplate should at a minimum expect that their unwillingness to use collective action clauses will be publicly noted in the course of IMF surveillance and that they will have unpleasant conversations with US authorities.
- If Mexico's decision does not catalyze rapid progress, US authorities—with the moral support of other creditor countries—could move beyond jawboning and start seriously arm-twisting the major investment banks. A handful of investment banks dominate the emerging market bond business. These investment banks could be summoned by the Treasury and the Federal Reserve and it could be made clear that the authorities expect them to follow the lead of JPMorgan and Goldman Sachs and to bring to market a new generation of bonds that have clauses. If not, the authorities would “name and shame” the investment banks that refuse to cooperate, and if this does not work, the authorities would seek legislation or regulation to achieve by fiat what the banks refused to do on their own. Similar pressure could be applied to major New York law issuers that do not follow Mexico's lead.
- A serious effort could be made to convince the SEC to require the use of clauses in SEC registered bonds.²³ The use of clauses could also be a requirement for access to the exemptions that allow qualified US investors to buy unregistered bonds. The SEC's mandate is to protect investors and assure the efficient functioning of markets. Traditionally, the SEC has sought to achieve investor protection through full disclosure and has shied away from regulating content. It

²³ Most issuers now try to issue global bonds—bonds that meet the registration requirements in all major markets—in order to maximize the number of investors who can buy the bond and therefore increase the bond's liquidity. It is unlikely that the use of clauses alone would lead the market to migrate into less liquid, unregistered securities.

- will not be easy to convince the SEC that requiring the use of clauses is part of its mandate. The G-7, however, could indicate that majority amendment provisions in sovereign bonds provided a crucial protection for investors, who otherwise run too high a risk that a restructuring might be hindered by minority litigation. International groupings of securities regulators could issue a similar statement. This might put pressure on the SEC to act. Of course, the SEC might be more swayed by investor arguments that clauses are not in the interest of investors.
- Ultimately, it might be necessary to make the use of clauses a legal requirement for bonds to be enforceable in the US courts. The Trust Indenture Act prohibits the use of majority amendment provisions in corporate bonds (in order to encourage restructurings through court-supervised bankruptcy processes). There is no fundamental reason why the law could not require the use of clauses in sovereign bonds to provide an agreed restructuring process in the absence of a court-supervised international bankruptcy process—though changing the law to change market practice is perhaps hitting a nail with a sledgehammer. Success is also not guaranteed: creditor groups undoubtedly would seek to influence the content of any legislation that was sent to Congress.
 - Mexico issues a \$1 billion, dollar denominated ten or twelve year bond almost every year. Both the initial premium on Mexico’s new bonds and the subsequent secondary market trading should provide a great deal of information about the upfront “cost” of using clauses. If this fails to provide sufficient information, it might make sense for the United States, or the G-7, to offer an emerging market economy that is prepared to issue a \$1 billion New York law bond in two tranches—one \$500 million tranche with standard New York law documentation, one \$500 million tranche with English law style documentation—enough cash to make sure that the issuer is fully compensated for any increase in spread associated with the use of clauses. Two tranches of the same bond that only differ in their documentation would offer clear evidence on the “price” the market would charge for clauses. Even if the tranche with English-style documentation is be sold at a lower price/ carries a higher initial spread, the spread/ price of the two bonds might converge over time.²⁴

It makes more sense for US authorities to try to engineer the change in New York market practice than to seek to condition IMF access on the use of clauses. The IMF does not have the leverage to engineer a coordinated change in market practice: it only has leverage over those who need to borrow from the IMF. These are countries that often don’t have a great ability to place any bonds in the market at the time they are seeking assistance from the IMF. It is hard to condition IMF assistance to a country on steps to solve a global problem, particularly if that step may not make it easier to solve the country’s specific problems. Finally, it would be hard to develop a consensus inside the IMF to make clauses a core part of IMF conditionality, given the votes of emerging markets on the Board.

²⁴ In an ideal world, it would be interesting to have both a sovereign with a strong credit rating and a sovereign with a lower rating issue two tranche bonds to see if the issuer’s credit rating had any impact on the spread differential.

It is important, though, to note that introducing clauses into New York law bonds will not fundamentally transform the existing sovereign restructuring process. Changing the provisions used in new bonds will not change the provisions already in the existing stock of bonded debt. Clauses do not offer the prospect of replacing issue by issue voting with a single aggregated vote. However, there is not enough evidence to date to indicate that these are fatal flaws. There are ways of trying to minimize the stock problem, and alternative ways of trying to coordinate a multi-instrument restructuring.

- Debtors that have outstanding New York law bonds typically already have the ability to amend all bonds terms except for the bonds key payment terms with the support of a majority or two-thirds of their creditors. Ecuador’s use of exit consents demonstrated that such provision can be used to create strong incentives for participation by increasing the cost of holding out. But ultimately, the stock problem likely means learning to live with a few holdouts, who will impose a tax on a successful restructuring. (If the debtor believes the holdout tax is too high, the debtor can avoid the tax by postponing the restructuring—delay is one potential consequence of the current legal structure)
- The stock problem largely solves itself in about 10 years—particularly if there are more Brady swaps/ other debt management operations that provide an opportunity to voluntarily redocument the long end of curve. Russia, Ukraine and Lithuania don’t have a stock problem—all their bonds currently make use of English law. And don’t forget that Argentina alone could introduce clauses in something like 10-20 percent of the outstanding stock of dollar and euro denominated international bonds (depending on the face value of the new bonds).
- Aggregation, in practice, may not be necessary—in part because most emerging economies do not have that many international bonds outstanding. Debtors have already discovered how to use exchange offers to coordinate the restructuring of different instruments. Creditors know the terms being offered to holders of a range of different bonds when they are deciding whether or not to go forward, and the debtor can assess how many holders of each bond have agreed to participate before going forward with the exchange. Of course, exchanges may work less well as the number of instruments goes up—Argentina will pose a real test. Ecuador did an exchange for 6 different bonds, Ukraine for 5. Argentina has roughly 80 different instruments outstanding.
- The JPMorgan proposal for a two-step exchange demonstrates in theory how a “market solution” could allow the debtor to buy an aggregated vote. It also has the advantage of forcing potential holdouts to commit at a very early stage to a holdout strategy—something that they may be reluctant to do. However, buying participation in the first step of the JPMorgan two-step exchange may not be the best use of a debtor’s scarce cash: the debtor may be better served by using that cash to sweeten the final deal.
- With or without clauses, it is still necessary to coordinate the restructuring of the sovereign’s external bonds with the Paris Club restructuring, and to coordinate the domestic and external debt restructurings.

A code of conduct for sovereign debt restructuring

The bottom line. A modest code is likely to be more robust than a more comprehensive and ambitious code. Specific proposals that are applicable across a range of cases are likely to be more useful than a set of general principles that are open to different interpretations. Any code needs to be balanced, and offer something to both debtors and creditors. Since creditors have a limited ability to act collectively and are not likely to be willing to commit to do much in advance, the requirements that the code imposes on debtors also should be limited. If creditors are willing to put more on the table, they can negotiate what additional steps the debtor will do in return. The code itself should aim only to set out the basic outline of a transparent debt restructuring process.

The creation of a code requires looking at the same two basic questions that arise in the contractual approach—what should be in code, and what will prompt creditors and debtors to make use of the code?

Any code needs to strike a balance between laying out broad general principles that are inherently open to multiple interpretations (terms like good faith, fair burden sharing and comparability of treatment) and laying out detailed prescriptions that may not be relevant in many cases. A code also needs to balance the interests of creditors and debtors—it cannot simply be a list of all the things a debtor should do to protect the interests of external creditors/ investors.

The creation of a code of conduct also may suffer from the same difficulty that has beset efforts to introduce clauses prior to Mexico's recent decision. Credible emerging market borrowers may not be willing to defend the interests of a debtor that must seek a restructuring. It is more pleasant for a debtor to discuss with its creditors all the reasons why their particular country will not need to seek a restructuring than to discuss the best way to manage a restructuring that all hope to avoid.

A code therefore must balance what it aims to do with the incentives that are available to assure that all parties will follow the code's basic precepts. There are many potential things a code could aim to do, and it is possible to mix and match. A code could:

- Set out the basic principles that should guide the restructuring process, as the Banque de France has suggested.
- Try to set out a roadmap for how to get from default to a successful restructuring.²⁵ This requires setting out the roles, responsibilities and modes of interaction between the various key parties in the game – the sovereign, its existing creditors (private investors holding international bonds, the Paris Club, private investors holding domestic instruments, the IFIs), and potential sources of new financing (the IFIs)

²⁵ It would no doubt generally be desirable to restructure prior to default. Pakistan was able to reach agreement with its bondholders to extend the maturity of its debt prior to formal default in 1999. However this may not always be a practical alternative, particularly in more complex cases involving multiple instruments and in those cases where the debtor needs debt reduction. Here, reaching agreement requires settling difficult issues of inter-creditor equity and it may not be possible—or even desirable given the drain on reserves associated with continued payment—to resolve all those issues prior to default. It is worth noting that using scarce reserves to make large principal payments to creditors holding claims with a short residual maturity disadvantages creditors holding debt with a longer residual maturity.

- Try to create a common law casebook that transforms existing practice into precedents that help to guide future restructurings. Problems tended to be solved as they arise rather than in advance; few problems fully anticipated. Unfortunately, the world hardly seems at the point where there is agreement on what should be taken from past experience—recent cases have highlighted some solutions to some specific problems, but most seem unsatisfied with some aspect of the current process.
- Create an instruction manual for a sovereign debt restructurings. There are a host of specific questions that arise in a restructuring. For example, how should different types of instruments (zero coupon bonds, the uncollateralized payments stream on a collateralized Brady bond) be valued in a restructuring? There is also the question of the right technique for assessing the comparability of the private debt restructuring and the “Paris Club” restructuring.
- Create a better telephone directory for a sovereign seeking to contact its creditors, and a better way to form a representative committee. This seems to be what Glenn Hubbard has in mind when he called for the creation of a new forum that would help bring a debtor that needs to restructure into contact with its creditors.
- Create a dispute resolution forum. Some form of mediation might be helpful in some circumstances. However, in the current legal environment, there is no obvious way to make any decisions of the “forum” binding on the entire creditor body.

Some provisions of a code may be self-enforcing, since all parties ultimately have an interest in a successful restructuring. But the power of these incentives should not be overstated. The debtor only has an incentive to follow the code voluntarily if it believes that it—not just the creditors—gets something out of the code. The commitments a debtor makes in a code need to be commensurate with the benefits the debtor ultimately receives. Moreover, the debtor’s incentives to abide by a code may be diluted if a quick restructuring of the debtor’s external debt is not the debtor’s top priority. The extensive discussion of collective action problems has made it clear that a debtor that works cooperatively with most of its creditors may still experience difficulty with a few, more aggressive creditors—be they nuisance creditors or more sophisticated creditors intent on using their legal leverage to try to extract a more favorable settlement. The classic critique of weapons nonproliferation treaties also applies to a code of creditor conduct; it only binds those that don’t want to proliferate. The IIF solves this problem by proposing a code of conduct with relatively modest commitments from creditors.²⁶

It is also possible to condition access to new money—notably new money from the IMF. This provides an additional means to encourage the debtor—but not creditors—to abide by the code’s provision.

But the difficulties of using the Fund’s lending into arrears policy to force a reluctant debtor to abide by a code should not be underestimated. The IMF has a number

²⁶ Bondholders would agree only to evaluate whether to continue to hold a bond on its own merits. Banks commit to “consider” rolling over their exposure, but recent experience suggests a bank can consider the pros and cons of rolling over their exposure, and then deciding to reduce their exposure. If the banks were willing to commit to rollover their exposure rather than just to consider that possibility in a concrete case, they would be in a position to make stronger demands on the debtor.

of goals following a default other than enforcing a code for restructuring external debt. In some cases, financing to support macroeconomic stabilization and try to mitigate the loss of output (and to limit the net transfer associated with quick repayment of the IFIs) may be a more important goal than quick agreement on an external debt restructuring. Consequently, the IMF is unlikely to be willing to make adherence to a code of conduct the sole criterion it uses to determine whether or not it will lend into arrears.

But there is still merit in a code that is focused on laying out in as concrete and as specific a way as possible what would be expected from the debtor during the restructuring process and also recognizes that a code cannot ask too much from the debtor so long as creditors are not willing (or perhaps not able) to offer much in return. More modest proposals are likely to be more robust.

Specifically, a code cannot

- Remove differences between restructurings terms amenable to mark to market institutional investors (maximizing cash upfront and the market value of restructured debt matter more than preserving face value) and restructuring terms amenable to the Paris Club (limiting the budgetary cost of a debt restructuring by protecting face value). The code must provide enough flexibility to allow the debtor, working with all its creditors, to shape its restructuring proposal to match the specific interests/ constraints of each creditor group. There is room to have a more honest ex ante discussion of how different groups should contribute to a debt restructuring, as the current state of play is a bit of a mess. The Paris Club traditionally does not reduce principal when it restructures the debt of middle income countries, no matter the size of the country's debts stock. Private sector creditors want all the available upfront cash flow the debtor generates, no matter what claims other creditor groups may have. The IFIs want to remain above the fray because of their de facto preferred status, but absent some refinancing of their exposure, the IFIs could place greater demands on a debtor's payment capacity than the debtor could realistically manage.
- Demand absolute equality or perfect "fairness" in the treatment of domestic and external debt. A debtor is not legally bound to treat domestic and external debt comparably, as Russia's Eurobond and GKO holders should know. Since domestic debt is often held primarily by the domestic banking system, treating domestic debt differently may be essential to limiting the scale of economic disruption associated with a default. The debtor may also conclude that domestic residents are likely to be its most important future source of financing, creating a "market" incentive to grant domestic debt preferential treatment. Finally, domestic debt is often held heavily by domestic residents and domestic residents are already contributing to the restoration of sustainability in many ways: higher taxes; fewer government services; and reduced external purchasing power of their domestic earnings. It is important to think seriously about how best to restructure domestic debt. But it is unrealistic to expect that a code should try to address the difficult questions of how to "fairly" allocate the pain inherent in a debt restructuring across all creditors, or how to strike the right balance between restructuring external debt and policy adjustments that impact on the country's own citizens.

Nonetheless, a code could lay out the minimal requirements for a cooperative restructuring, create expectations that will shape how all parties perceive their interests, and provide a roadmap for governments in the middle of an economic and political crisis. Specifically, a code could usefully do four things:

1. Lay out in detail a set of disclosure requirements that a debtor would be expected to meet during the course of its private external debt restructuring. These requirements would not assure a faster restructuring process—but they would force the debtor to lay out how it was treating different creditor groups in much more detail, and in a much more comprehensive manner. Specifically, a debtor should be expected to lay out, in considerable detail and soon after its default, the full spectrum of its outstanding debts—and to provide regular updates. It should also outline its proposed timeline for the restructuring. At the time it puts forward a restructuring proposal, it should also put on the table, as the IMF has suggested in its SDRM proposal: a list of claims that are being restructured through the initial proposal, a list of claims that will be restructured in other ways, and a list of claims (including previously restructured claims and debts to the IFIs) that are not being restructured. The debtor should further indicate how available cash in the near term is being allocated to service different creditor groups, and how significant a claim each creditor group will make on the debtor's ability to generate resources over the medium and long-term. If the debtor is asking the private sector to restructure prior to the Paris Club, it would be reasonable to expect the Paris Club Secretariat (after consultation with members of the Paris Club) to indicate whether the debtor's proposal is likely to generate support among Paris Club creditors. In other words, if the debtor's plans call for Paris Club debt reduction, the Paris Club could signal in advance if such reduction is—or more likely, is not—in the cards.
2. Lay out a set of basic expectations for how the restructuring of that part of the sovereign's external debt held by private creditors should unfold. This also has three components. First, the debtor should be expected to consult with creditor representatives, including organized creditor committees, as it develops its restructuring proposal. Consultation means being informed about the contours of an IMF agreement, not being able to block an IMF agreement that creditors do not like—creditors who are not putting up new money cannot have a veto over the provision of new money by the IFIs. This consultation would be expected to be much more extensive prior to the launching of an actual restructuring proposal by the debtor. Second, creditors should organize themselves so that they can provide constructive input into the restructuring process. Third, creditors should expect that the debtor will make use of its existing legal leverage—including provisions in bonds that allow the amendment of financial and nonfinancial terms—to discourage holdout creditors. The aggressive use of such provisions to deter holdouts is part of what has helped to make the number of holdouts manageable in recent restructurings. The amendment of nonfinancial terms is part of what has made the status quo work. Both consultation and the amendment process will support a multi-instrument exchange offer. An exchange offer, as discussed

- earlier, allows the debtor to coordinate the restructuring of different instruments, to the advantage of both the debtor and creditor.
3. Introduce a clear expectation that external and domestic debt are unlikely to be restructured on the same terms. There needs to be some balance between the pain that domestic residents, including residents who hold domestic debt, absorb and the pain that external creditors absorb. But a code should not do more than demand that the debtor to lay out how it proposes to treat both domestic and external debt. The right treatment of domestic debt truly will depend on the circumstances.
 4. Introduce a clear expectation that any new bonds issued as a result of the external debt restructuring will make use of collective action clauses. Comprehensive restructurings offer a golden opportunity to solve a country's "stock" problem. Most of the bonds in the EMBI originated in some form of debt restructuring—be they Bradies, the globals that emerged from Brady-to-global swaps, or Russia's 30 (created in the London Club swap). This will be all the more true after Argentina restructures its bonds.

Such a code offers something to both the debtor and its creditors, and makes it clear to all participants in the market that there is a recommended process for going about a sovereign debt restructuring. It seeks to strengthen the expectation that the debtor will disclose in detail the composition of its debt stock and its restructuring plan. The goal is to map out the process that already basically exists—one based on consultation with creditors leading to an exchange offer, combined with the use of various amendment provisions to limit the risk of holdouts. The Paris Club would continue to condition its restructuring on the debtor seeking a comparable restructuring from private creditors—and could continue to interpret comparability of treatment flexibly. Private creditors also would be free to link their willingness to restructure to the debtor's willingness to seek a similar restructuring from other creditor groups. But the code would only demand that the debtor be transparent about its plans, not to mandate any particular outcome.

The IMF obviously has a role in ensuring that debtors live up to the transparency and disclosure requirements set out in the code. Indeed, the transparency requirements/information provision requirements could replace the vague and ultimately unenforceable good faith test in the IMF's lending into arrears policy. In theory, nothing would preclude a debtor and its creditors from concluding a restructuring that followed the basic process set out in the code in the absence of an IMF program. However, in practice, it would be difficult for a debtor to put forward a debt restructuring proposal that met the information disclosure requirements in our suggested code without an IMF program – if for no other reason that the amount of new money from the IMF is crucial to assessing how large a claim the IFIs will be making on the debtor's near term debt servicing capacity. The adjustment path laid out in an IMF program also provides the analytical basis for determining the level of payments the debtor can support in both in the near term and over the medium-term.

In some circumstances, a debtor might be willing to make commitments that go beyond the relatively modest requirements set out in the code in return for more concrete and specific commitments from creditors. If a given creditor group is willing to rollover their claims, to put up new money, to agree not to take legal action to collect on their

claims, or even to agree among themselves that they will take all decisions by a supermajority vote (those who have the right to holdout would agree not to holdout if a critical mass of other creditors agreed to the debtor's terms), the additional commitments from creditors could well be matched by additional commitments from the debtor. On a more modest scale, the debtor could agree to pay the fees of advisors selected by a representative committee of creditors that demonstrates that it is committed to a cooperative restructuring. The basic parameters of the proposed code are intended to be applicable across cases, not to prevent the debtor and its creditors from making additional commitments in any given case.

It is also worth saying a bit more about the role creditor committees could play in the sovereign debt restructuring process. The role of committees needs to be adapted to a world dominated by markets, not banks. The relationship between the committee and the broader creditor community will inherently be different than it was during the period when sovereign external financing took the form of large loan syndicates. In such a world, there was an expectation that agreement with the committee meant agreement with the broader group of creditors—part of the responsibility of the lead banks was to rope in other banks.²⁷ A committee of bondholders cannot exercise comparable influence over other bondholders: each bondholder will decide on their own whether or not to accept the debtor's restructuring proposal. An exchange whose terms are negotiated between the debtor and a committee of its creditors may still fail—particularly in the sovereign context where the debtor lacks the ability to hold an aggregated vote and cram down restructuring terms.

This is not to say that committees cannot play a constructive role—support from a committee composed of creditors who have similar interests to other creditors can encourage wide participation. Moreover, a committee that collectively holds enough debt to block a deal is a force that any debtor must deal with. However, in a world where agreement with a committee does not “deliver” the support of all creditors, including creditors that are not part of the committee, the official sector should not insist as a condition for its own lending that the debtor always reach agreement with the full creditor's committee before it goes forward with an exchange. This is all the more true if the internal rules of the committee require unanimity before the committee as a whole will endorse the restructuring proposal. This implies a role for creditor committees that may fall short of formally negotiating the terms of the exchange offer with the debtor.

Moreover, when creditors have disparate interests, there may be advantages to having several committees rather than trying to organize a single steering committee that represents all creditors. For example, it remains to be seen how best to develop a deal that provides Argentina with the relief it needs, reflects the different preferences of different groups of creditors, and is perceived as treating all groups comparably, if not equitably. The official community should insist that Argentina lay out its proposed treatment of all groups of creditors for all to see, so that all groups know what is being sought from other groups before they commit to any restructuring. But it is not obvious that the official sector should insist that Argentina create a single steering committee that represents all Argentina's creditors rather than work with representatives of various creditor groups that have a stake in the process.

²⁷ Veterans of the 1980s point out that reality often fell short of this ideal. The leverage of large banks was limited and, in the end, each bank and its board made its own decision.

The Statutory Approach

The bottom line. The hurdle for introducing an untested statutory regime has to be higher than the hurdle for introducing regulation that requires the use of clauses. The market's acceptance of English law documentation limits any risk associated with regulations requiring the use of English law documentation in New York law bonds. There is a risk that imposing an untested statutory regime on issuers and investors could disrupt the market. Partially as a result, there is not going to be political consensus to introduce the SDRM in the near term. Rather than debating the details of a single specific design, it makes more sense at this early stage to focus on trying to agree on the broad problems a statutory regime should aim to solve. The details of the design can follow later.

The timeframe for creating an SDRM is likely to be closer to 10 years than 10 months. There is not currently the level of consensus among major creditor countries, issuers and market participants that is needed to even try to build the requisite political consensus to create a supernational approximation of a bankruptcy regime by amending the IMF's Articles of Agreement. This is part of the reason why it makes sense to stop studying the relative merits of changes to contracts and creating new statutes and to start changing contracts. But it is also worth trying to capitalize on the investment the international community has made in the statutory approach by making a final push to reach agreement on what a statutory proposal—should one eventually be developed—try to do. Of course, without the impetus created by the need to act, efforts to consult market participants may founder—and it may not be possible to reach agreement on the basic contours of what a statutory regime should aim to do without a deadline that drives compromise.

A short list of series of broad issues that need to be resolved before the world will eventually be able to converge on a design should include:

- What, in broad terms, should a statutory regime look like? Should it aim to create something that looks like an exchange offer for external bonds but with aggregation across multiple instruments—a rather limited transformation of the existing restructuring process? Or should it aim to create something that looks more like domestic bankruptcy, with a much higher level of court supervision of the process (and of the debtor)?
- Is there a need to provide the debtor with legal protection prior to a restructuring, or is the capacity to bind in holdouts at the time of a restructuring enough?
- Should creditors be able to vote down a debtor's request to make use of the statutory framework?
- Do you need senior new financing from the private sector, given the ability of the IMF/ MDBs to already provide senior new financing to a distressed sovereign?
- What types of debt should be part of the supernational restructuring process? The unsecured external law debt of the central government (and the central bank if it approves) held by private creditors, or something more?
- What obligations does the debtor incur if it wants to make use of the statutory regime/ cramdown provisions? Is the goal is to make it easier for the debtor to do the restructuring that it wants to do so (creating incentives for the debtor to

- develop a plan/ act on it)? Or is the goal to constrain the types of restructuring the debtor can do if it wants to use the statutory regime, and thereby make the process/ outcome more predictable?
- What role for a dispute resolution panel (and what type of panel)? Is the objective to create a panel composed of technical experts whose role is limited to making the technical judgments needed to make aggregation process work/ protect integrity of aggregated vote? Or is the role of the dispute panel to deliver “neutral” opinion/ act as a mediator on many of the broad questions that arise in the restructuring, including what payments stream is consistent with sustainability?
 - How to aggregate? The practical difficulties of developing an alternative to issue by issue voting should not be discounted. Applying domestic bankruptcy would imply that all debt would be classified and participate in an aggregated vote, and the court would oversee the classification of instruments proposed by the debtor.²⁸ Alternatively, the debtor could be given discretion to determine what instruments participate in the aggregated vote, minimizing the need for a third party or a “court.”²⁹

A key question is whether the observed problems in the sovereign debt restructuring process can be addressed by a design that aims to create something that would look like an improved exchange offer rather than by a design that would result in a process that more closely resembles a “classic” corporate bankruptcy regime. Argentina’s experience will help answer this question. The number of Argentina’s outstanding instruments, the diversity of its creditor base (particularly the large number of retail investors), the legal complexity of its external debt stock, the importance of both domestic and external debt to Argentina’s future debt sustainability and the sheer scale of the needed restructuring assure that Argentina’s restructuring will give rise to almost every problem that could arise in a sovereign debt restructuring. If Argentina demonstrates clearly that the current regime cannot be made to work in complex restructurings, issuers and investors alike may reassess their opposition to an ambitious statutory regime.

At this stage, however, it seems that there is little need to aim for more than an “improved” exchange offer. Debtors already have the ability to suspend payments on their debt to prevent the sovereign’s own creditors from rushing to the exits. The debtor’s international reserves already enjoy considerable protection while it develops a restructuring proposal, and the debtor’s sovereignty protects its “domestic” assets from external litigation. The difficulty in suing a sovereign and collecting on a judgment already inhibits any rush to the courthouse. The prime gap created by the current legal regime is the absence of a clean way to address potential holdouts at the conclusion of a restructuring. If a design that provides the debtor with relatively limited additional

²⁸ The “court” would be able to deliver definitive judgments on the meaning of terms like “sovereign” and “foreign law” that are open to interpretation.

²⁹ One implication of giving the debtor substantial flexibility the debtor is that the debtor will continue to be able to try to impose its own “priority” structure on the restructuring by choosing which instruments it seeks to restructure and which instruments it wants either to exclude from the restructuring or to restructure in other ways. Limiting the role of the “court” necessarily means limiting the ability of the “court” to constrain the type of restructuring the debtor is able to propose.

capabilities -- primarily the ability to bind in a minority with the support of a supermajority—would work, it is not necessary to balance the debtor’s modest additional powers with substantial limitations on when it can make use of these powers.

One consequence of this view is that a stay on litigation may not be necessary in the sovereign context.³⁰ The ability to bind a minority to a restructuring agreed by the majority would eliminate the main known technique for effectively litigating against a sovereign—holdouts that try to “attach” the new external payment stream. The argument that the absence of stay would result in a bankruptcy regime that fails to create incentives for earlier initiation of restructuring by the debtor seems overstated. It is difficult to believe that the threat of ineffective litigation currently creates strong incentives for a sovereign to delay a restructuring. There are other far more important reasons for a sovereign to delay, and for the official sector to prefer financing to a precipitous move to a restructuring.

The need for private “DIP” financing is also not obvious in the sovereign context. Sovereigns’ may be able to operate on a cash basis more easily than firms, and sovereigns in default on their external debt often have access to either domestic financing or to financing from the IFIs.³¹ Practically, the creation of absolute priority is difficult without the ability to liquidate the debtor—at best a court can enforce a system of relative priorities.³² Given that a sovereign debtor’s “management” cannot be changed by creditors following default and given that the debtor cannot be placed under the control of a court, there also could be advantages to assuring that any new money comes with policy conditionality.

Similarly, a design that covers only the sovereign’s external law debt, and gives the debtor substantial flexibility to determine which external law instruments it wants to restructure³³—as the IMF has proposed—should be sufficient to achieve the basic goal of making it easier to reach agreement on a consensual restructuring of the sovereign’s external debt without the need to pay off a set of holdout creditors. Obviously, such a design would not help coordinate the bond restructuring with a domestic debt restructuring or a Paris Club debt restructuring. But the restructurings done by different creditor groups can be coordinated in other ways. As now, each creditor group can condition its willingness to restructure on the actions of other creditor groups. This is not to discount the difficulties posed in restructuring domestic-law debt: the spillovers from a domestic debt restructuring to the banking sector are the biggest impediment to

³⁰ Giving the IMF the power to provide even a temporary stay would be perceived by creditors as tilting the playing field against their interests. However, giving a super-majority the ability to impose a stay on a minority would not tilt the playing field against creditor interests—in practice, a debtor would be hard pressed to ever convince a super-majority to vote for a formal stay.

³¹ Sovereigns typically don’t need trade credit; firms that import and export do. Simply excluding trade credit from the restructuring/ any capital controls may work better than seeking to create formal priority for trade credit.

³² Priority in the corporate context comes from priority claim on the firms liquidation value—ultimately, it is the court’s ability to assure that “priority” creditors are paid first in the even of liquidation that assures payment. In the sovereign context, nothing can stop a sovereign from stopping payments on priority as well as non-priority debt. The priority creditors cannot force “liquidation” and get paid. The best a court can do is assure that any external payments that are made follow the rules of priority.

³³ While the debtor can try to “pick and choose” which instruments to include in a restructuring, creditors would not agree to a restructuring that left out important categories of debt unless there was a strong justification.

restructuring sovereign debts, and Argentina's experience suggests that the constitutionality of "imposed" domestic debt restructurings can be challenged. However, including domestic debt in an international bankruptcy regime raises a host of problems in return for only modest benefits: it substantially infringes on the debtor's sovereignty without obviously making a restructuring easier.³⁴ Domestic debt will need to be restructured in some circumstances, but there is no evidence that suggests that an international bankruptcy regime will make that restructuring easier. There are already processes for restructuring domestic debt if necessary.

A different conception of the problems that a statutory regime needs to resolve would result in a different design. However, there is no need to insist that a bankruptcy regime for sovereigns has to resemble existing bankruptcy regimes for firms in order to be effective. Sovereigns are not firms, and the absence of features that are essential for firms may not pose the same problems for a sovereign. Conversely, a sovereign may have a need for some things that firms do not. It would also be a mistake to assume that legal change will help solve problems that stem do not stem fundamentally from the threat of litigation. It is possible to try to use changes in the legal regime to address problems that are not primarily legal in nature—for example, access to legal protection can be conditioned on various other actions by the debtor. But it is important to be clear precisely why there is a reasonable basis to believe changes in the legal regime would solve other problems that arise in the restructuring process. For example, giving the debtor protection from litigation by external creditors won't in and of itself stop a run out of the domestic banks, nor will it stop a run on the defaulting country's currency.

A Concluding Observation

There is indeed a strong case for taking action to address those collective action problems arising from the risk of litigation. Collective action problems arising from litigation are conceptually among the easiest problem to solve—and it is comparatively speaking easy to identify a set of contractual changes that significantly reduce the risk that holdouts would have the legal leverage to be able to disrupt a debt restructuring. There is no evidence that introducing such clauses would dilute an issuer's incentive to pay. And if the market's willingness to hold Russia's English-law dollar-denominated debt is any guide, the use of such provisions should not cut emerging market sovereigns off from the international capital market.

However, it is also important to remember that holdout litigation—and the delays that may emerge from steps the sovereign takes to limit the risk of holdout litigation—is not necessarily the most important problem that a sovereign that needs to restructure will face. Default on sovereign's debt also typically leads to a run on the country's currency, a run on the domestic banking system (unless bank deposits already have been frozen), and

³⁴ When a debtor issues international debt, it voluntarily agrees to submit to the judgment of an external court. Countries issuing domestically make no such commitment. Including domestic debt in the SDRM effectively turns domestic debt into international debt—if effective ways can be found to enforce the court's judgment on domestic debt. Adding in domestic debt also vastly increases the scope of the proposal. The stock of outstanding "international" emerging market bonds is, by our rough calculations, well under \$500 billion (probably more like \$300 billion than \$500 billion). The United States alone has over \$3 trillion in marketable domestic debt securities outstanding. Emerging economies like Brazil and Turkey have far more sovereign domestic debt outstanding than international debt.

a rush to sell other domestic financial assets—all of which augment the real economic costs of the restructuring. Indeed, looking forward, the biggest impediment to sovereign debt restructuring is likely to be the challenge created when the sovereign's major creditors are domestic banks, and restructuring the liabilities on the sovereign's balance sheet cannot but have a major impact on the asset side of banks' balance sheet. This is not an easy problem to work through—it requires choosing between many bad options. But this is a problem that warrants the same detailed, serious discussion that went into the effort to develop new clauses for sovereign debt contracts.