

THE SOVEREIGN DEBT FORUM: EXPANDING OUR TOOL KIT FOR HANDLING SOVEREIGN CRISES

RICHARD GITLIN AND BRETT HOUSE

KEY POINTS

- A sovereign debt forum (SDF) would assist in facilitating more predictable, transparent and timely treatments of sovereign crises during future episodes of debt-servicing difficulties. An SDF would provide a non-statutory, neutral standing body to identify lessons from past episodes of sovereign distress, maintain information on sovereign debt and convene stakeholders to engage in confidential discussions at the outset of a sovereign crisis.
- The SDF proposal takes inspiration from existing precedents, such as the Paris Club and Vienna Initiative, which demonstrate that informal, rules-based representative entities have a long-standing history of organizing effective workouts for distressed countries
- An SDF would have a limited remit: to enable early, discreet consultation and information sharing between distressed sovereigns and their creditors to speed the process by which a sovereign is returned to solvency, stability and growth. An SDF would not supersede existing institutions and would rely on close collaboration with the International Monetary Fund (IMF).
- An SDF would complement other proposals for automatic maturity extensions on securitized debt, arbitration and mediation processes, voluntary standstills and improved aggregation in collective action clauses (CACs).
- The SDF and other incremental, pragmatic proposals to improve sovereign crisis management should be put at the core of the G20 agenda on an ongoing basis.



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INTRODUCTION: THE CASE FOR AN SDF

Three impediments to the pursuit of early, efficient and effective resolution of sovereign crises continue to mark the international financial architecture. First, sovereign governments are generally reluctant to recognize the severity of a crisis, hoping that circumstances will change and the difficulties they face

will abate. Second, creditors are also keen to defer entering discussions with a debtor sovereign in the hope that multilateral and bilateral support to the sovereign will allow creditors to be paid in full and eliminate any payment difficulties occasioned in a crisis. Third, other sovereigns may wish to see efforts to address a crisis forestalled out of fears that such efforts could cause contagion and materially worsen their own circumstances.

Over recent decades, the costs imposed by these impediments have risen. Cross-border capital flows have expanded exponentially, the variety of sources of sovereign finance has widened and an increasing share of sovereign borrowing is raised through bond issuance rather than through bank credit. The scale of sovereign obligations that have to be treated in crises has grown immensely and, concurrently, so too have the consequences of delays in taking action to restore sovereign solvency when it is under threat.

Despite some substantial efforts, there is still little structure in place to address sovereign crises when debt servicing problems arise among this ever-more diverse set of borrowers, creditors and financial instruments. As the IMF (2012) notes, debt treatments happen eventually if distressed sovereigns require them. Nevertheless, Europe’s ongoing challenges, in particular in Greece and Cyprus, and the recent efforts in New York courts to reopen *pari passu* issues related to Argentina’s 2005 restructuring, are together testament to some of the externalities generated by the absence of a more systematic approach to sovereign crisis management and the need for a more effective framework.

Any attempt to mitigate the aforementioned impediments to faster and less costly resolution of sovereign crises needs to be incentive compatible.

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Existing market-based coordination mechanisms are not sufficient on this criterion. The increasingly frequent inclusion of CACs in sovereign bond contracts and the European Union's commitment to expand further the use of CACs should ease the process of inter-creditor coordination in future debt treatments. But the design of CACs requires more work: in the 2012 Greek restructuring, Zettlemeyer, Trebesch and Gulati (2012) note that CAC votes were attempted for 36 foreign law issues, and failed in 19 of these cases. Even when CACs are effective, they do not in and of themselves bring stakeholders together to assess a sovereign's solvency and craft viable responses at an early stage. Instead, CACs, and the threat of their possible invocation, may simply speed the process of inter-creditor coordination and decision making once the terms of a macroeconomic adjustment program and a debt treatment have been proposed to unwind a sovereign crisis. The world still lacks a simple and effective mechanism to articulate and agree on these terms.

This policy brief proposes the creation of an SDF to address this gap by laying out the following: a small set of principles that ought to inform any efforts to enhance the international financial architecture's capacity to handle sovereign crises; the contours of a possible SDF; some processes by which an SDF could operate; a broad sketch of the incentives for stakeholders to participate in the SDF's operations; and some recommendations on possible next steps. This brief is intentionally parsimonious. It is intended simply to consider the basic features of an SDF and catalyze discussion by sovereigns, creditors and other stakeholders toward action on an SDF in the coming years.

The brief builds on Richard Gitlin's 2003 proposal for an SDF and updates the concept for present

circumstances. An SDF may be seen as an end in itself, a straightforward enhancement of current practices, a building block toward an eventual statutory framework, or a complement to such a framework. In any event, an SDF would support and augment other current proposals to enhance the international financial architecture by helping all constituencies in sovereign crisis resolution to act earlier, more efficiently and more effectively.

PRINCIPLES: SOME FOUNDING TENETS FOR REFORM

The addition of any new body to the international architecture for handling sovereign crises should respect a number of key founding principles. These include:

- **Stability, independence, neutrality and impartiality.** Any new body should feature all four of these core qualities.
- **A limited remit.** With many actors already in the international system, any new addition should be designed to ensure that its mandate does not overlap with existing institutions. Instead, it should be a convener and provide a venue for existing actors, unless it can be shown that there are important functions that are not already being fulfilled by existing bodies that could be executed best by this new actor.
- **Facilitation of early, proactive discussion in a confidential setting.** Past sovereign crises demonstrate the need to convene stakeholders at an early stage in a confidential setting with substantial information sharing in order to move quickly and efficiently toward effective crisis remedies. Any new international body or venue should assist in making this happen.

- **Enhanced transparency in outcomes.** The experience of past sovereign crises also highlights that the collective response to a crisis needs to be clearly and accessibly explained to enhance the credibility and ownership of the remedies adopted.
- **Leanness.** A substantial increase in the existing corps of international public servants should be avoided. An effective addition to the process of resolving sovereign crises should be feasible on a limited budget and with a small staff, some of whose members may be seconded from existing institutions.

THE PROPOSAL: KEY FEATURES OF AN SDF

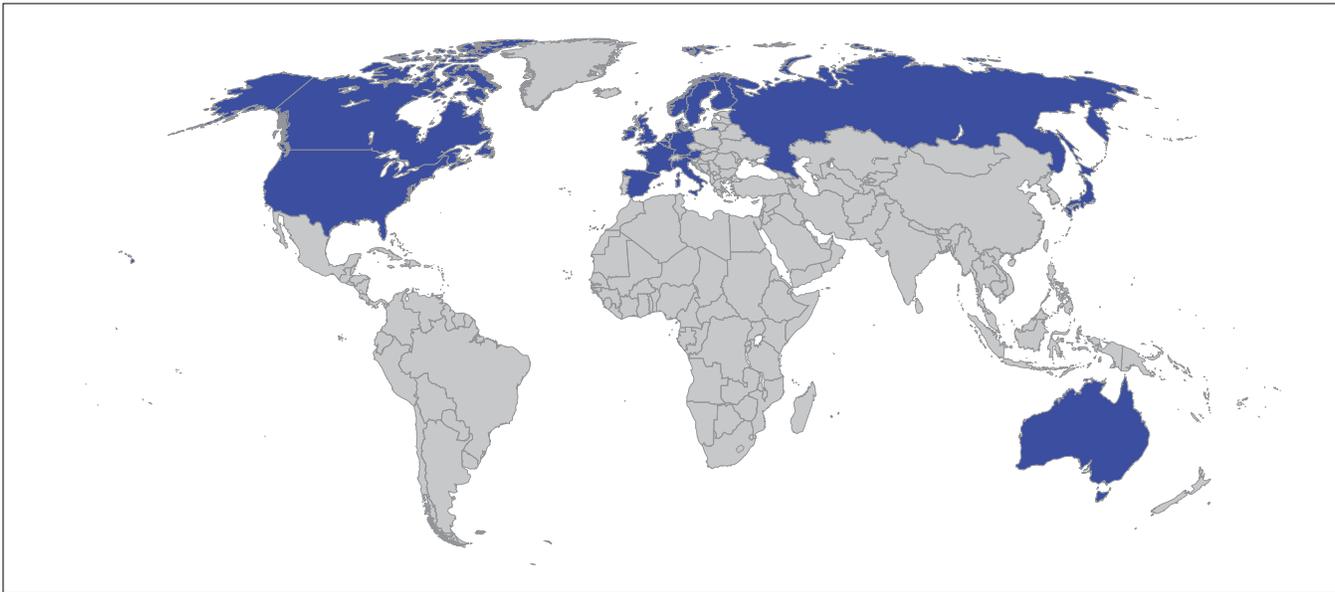
Non-statutory, non-institutional, uncodified. The SDF would not be a multilateral institution: it would not be created by statutory agreement, but rather by informal consensus among stakeholders. This approach reflects the observation that there appears to be little appetite in the current environment for the pursuit of a statutory-, convention- or treaty-based approach to handling sovereign crises. The SDF could exist as a virtual non-institution, housed and staffed by an existing body, such as an international non-creditor financial institution or an international non-governmental body. Alternatively, it could be incorporated as a discrete non-profit entity in its own right in a single jurisdiction.

Agreements reached under the auspices of the SDF would not necessarily need to be legally enforceable. Much can be achieved without formal legal enforceability. For instance, the Paris Club’s agreed minutes provide the guidelines for sovereign debt restructurings, but their terms are implemented through bilateral agreements. The SDF’s work could be based

on a number of concerted, yet informal, guidelines and principles to be outlined by its constituents and developed over time through individual case work and precedent. Such touchstones would facilitate open and informed decision making, and more rapid conclusion of consensus on the appropriate responses to future episodes of sovereign distress. The SDF would not, however, constitute a formal arbitration process as championed by the Jubilee Coalition and others under the banner of the Fair and Transparent Arbitration Process outlined by Raffer (2005).

The Paris Club’s successful operations since 1956 demonstrate both the potential effectiveness of such an informal, yet rules-based, standing body and the need to broaden its membership. The Paris Club’s skewed composition, shown in Figure 1, highlights the ongoing need for a more inclusive format, with a balanced membership, for the comprehensive exchange of information and negotiation on crisis resolution and treatments of a wider range of sovereign obligations to an ever-more diverse body of creditors. Admittedly, a larger body may find it difficult to generate the same intimacy of relations between sovereign creditor representatives that underpins the Paris Club’s effectiveness; however, the absence of such intimacy among the growing field of sovereign stakeholders points to the need for a body in which this closeness can be built.

FIGURE 1: EXISTING PARIS CLUB PERMANENT MEMBERSHIP



Fair, balanced and comprehensive representation. Membership should be reasonably open and should include relevant constituents in the sovereign debt and policy community: sovereigns, representatives of major creditor classes, legal bodies, academics and others. The set of representatives party to an SDF process could be fluid depending on circumstances, the debtor under consideration and the particular challenges it faces. The creation of standing member advisory groups would be encouraged during non-crisis periods to ensure constituents' interests can be represented quickly, fairly and clearly during times of sovereign distress without overburdening the SDF's processes. International consortia such as the Consultative Group to Assist the Poor (CGAP) provide precedents for independent multi-stakeholder bodies that bring together governmental, multilateral, private and non-governmental participants and are housed in major multilateral institutions (the World Bank in the case of CGAP).

Neutral venue. To preserve the SDF's neutrality while allowing it to be built quickly and practically, it could

be housed in a multilateral institution that is not itself a creditor, located in a major financial centre, such that meetings would be relatively easy for members to attend. For instance, the Bank for International Settlements, which was originally charged with overseeing the resolution of international debt problems arising from German war reparations, could be a host institution for the SDF. Alternatively, as is the case with the Paris Club, the SDF could be hosted in the capital of a country willing to house the SDF at one of its governmental institutions, but this may be seen to condition the SDF's impartiality. If the international community decides to incorporate the SDF as a non-profit institution, it may also decide to house the SDF on a stand-alone basis.

SDF "lite." The creation of the SDF's functionalities is more important than adding another set of initials to the alphabet soup of international organizations. A "lite" initiative to build the SDF's core elements into the international financial architecture could also be accomplished by creating a unit at the IMF along the institutional lines of the IMF's Independent Evaluation

Office. A lite approach to creating an SDF could also be effected through a simple expansion of the existing Paris Club’s membership and processes. While practical, both of these approaches would, however, leave the SDF inside creditor-dominated bodies.

Staffing. The SDF would require a small, full-time standing staff of legal, financial and economic experts. It should be lean and minimalist in its construction. The SDF staff could be built through secondments from SDF members or *de novo* hires. The staff would be expected to act independently and impartially, with full detachment from any sponsoring institutions.

Financing. The SDF would need secure, multi-year financing in order to preserve its neutral standing. There are a number of options for financing the SDF’s operations, including, inter alia: multi-year contributions from members; contributions toward an initial endowment; or a small fee assessed on bond issuers or purchasers.

MAKING THE SDF OPERATIONAL

The SDF would, as necessary, organize inclusive consultations for informed and timely negotiations on the sovereign’s obligations that would build on the Institute of International Finance’s (IIF) *Principles for Stable Capital Flows and Fair Debt Restructuring* (2012) and the IMF’s policies on lending into arrears.

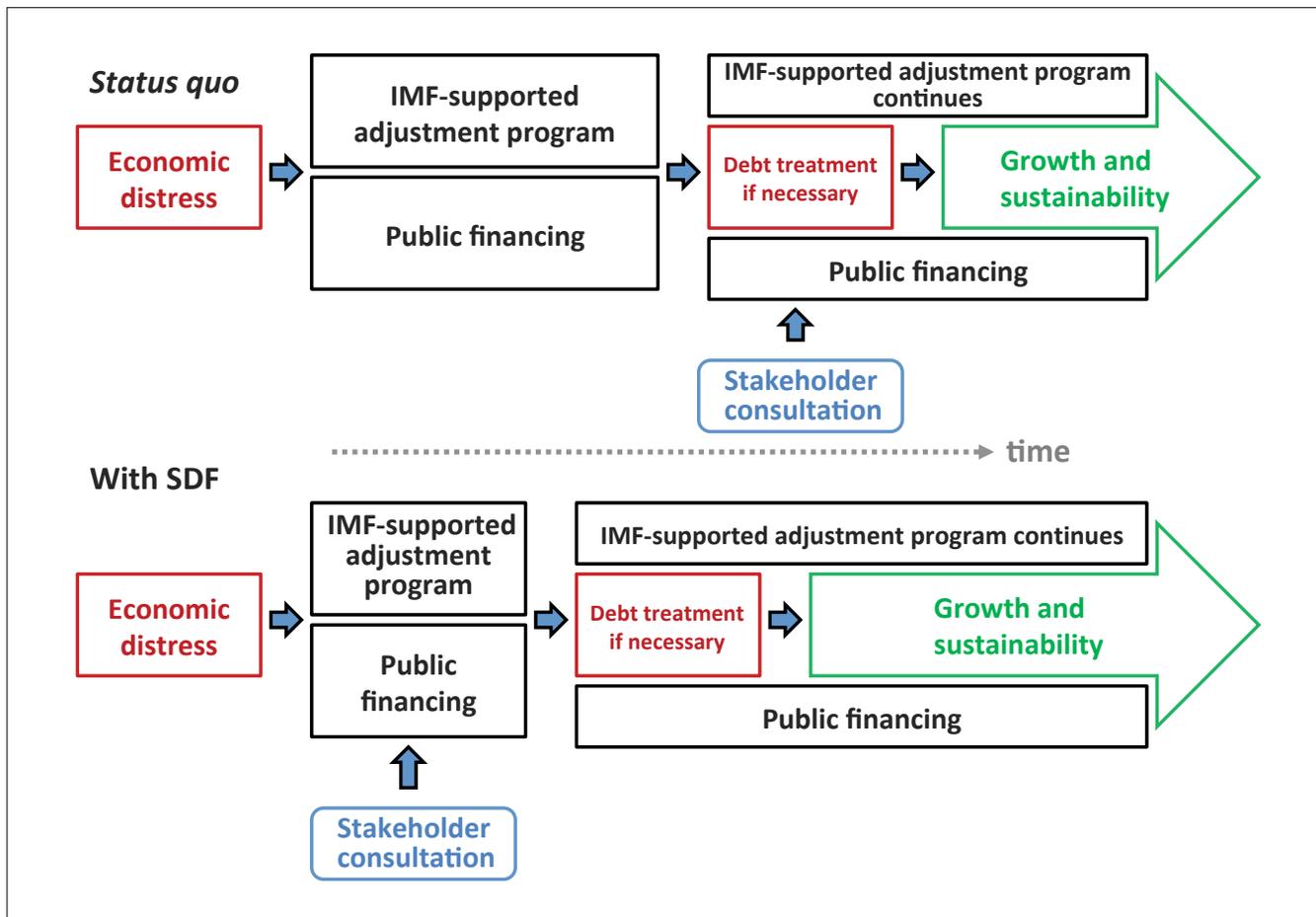
Coordination with existing representative and negotiating bodies. The SDF would consult closely with existing representative and negotiating bodies, such as the Paris Club; other creditor committees or representative bodies, such as the IIF; the Financial Stability Board (FSB); the Organisation for Economic Co-operation and Development’s (OECD) Development Assistance Committee; and the international financial

institutions. Coordination with the IMF’s work on the debt sustainability analysis (DSA) and any adjustment program would be central to the SDF’s work. The SDF would facilitate exchanges between stakeholders of data and analyses on the sovereign debtor to fine-tune remedies under consideration for the sovereign’s distressed state.

Sequencing. Most importantly, the SDF should hasten consultation on a sovereign’s solvency among relevant stakeholders in a neutral, confidential setting. It should reverse the usual sequence of crisis management when sovereign solvency is questionable. Instead of initial public lending into an adjustment program followed by a possible debt treatment to create sustainability, use of the SDF should prompt earlier determinations on solvency, incite faster movement to treat debt should it appear necessary and stimulate subsequent lending to foster growth in the context of a sustainable debt stock, as shown in Figure 2.

Greater speed in execution. By maintaining a standing body between episodes of sovereign distress, the SDF would enable the international system to respond to debtor and creditor needs more quickly and efficiently than under current ad hoc arrangements. Creditor and debtor representatives and advisory groups could be given regular updates and kept current. When necessary, structured processes could be initiated smoothly without reinventing the wheel for each distressed sovereign, while maintaining the flexibility to innovate on specific points. Maintaining a standing SDF with periodic regular discussions on emerging vulnerabilities may also reduce the reluctance of sovereigns to trigger such processes.

FIGURE 2: CRISIS RESOLUTION WITH THE SDF ADVANCES STAKEHOLDER CONSULTATION EARLIER IN THE PROCESS



Content of discussions. Initial SDF discussions would focus on the design of the sovereign’s macro program, the sustainability of its debt and its capacity to pay, all building on work by the IMF in conjunction with the sovereign. Discussions could eventually move to consideration of the terms of a possible debt treatment— or the measures needed to avoid a treatment— always keeping in mind the need to support the sovereign’s capacity to grow out of its crisis, and maintaining the presumption that creditors should be made whole whenever possible. Initiation of discussions under an SDF would not presuppose automatic movement to a debt treatment.

Comparability of treatment and fair burden sharing. SDF members would commit to processes that would ensure, to the greatest extent possible, comparability in the treatment of claims, limits on free riding and follow-through on fair burden sharing. Advisory groups would be encouraged to review general procedures, specific negotiations and debt treatments to ensure that these principles are maintained in the face of any potential collusion among subsets of constituents.

Enhanced confidentiality and transparency. SDF members would be expected to participate in the forum’s proceedings with an enhanced level of confidentiality in return for greater inter-member transparency. This would ensure support for and

credibility in discussions of the debtor's macroeconomic program, the adjustments the sovereign proposes to undertake, assessments of the sovereign's capacity to pay, burden sharing among creditors and the terms of any possible debt treatment, should one prove necessary.

Building on, but not bound by, precedent. The SDF's informal nature would allow it to evolve rapidly and adjust to circumstance, while its professional staff would continue to inform SDF members of the lessons and insights of past experience. As a non-institution, the SDF's deliberations and eventual understandings would be recorded in minutes that would outline agreed actions and information. As in Paris Club processes, these agreed minutes would have no legal standing and, hence, would not represent binding precedents.

Subsidiarity. No aspect of the SDF's work would be intended to replace, challenge or supersede the work of existing processes or institutions. For instance, SDF staff would not be charged with developing alternatives to members' analyses; instead, they would be tasked with transparently reconciling competing data and analyses from the SDF's members in the discovery and negotiation process in order to help build balanced views on needed macro adjustments and the possible treatment of any relevant debt. Most notably, this would enhance the credibility and ownership of the DSA and adjustment program among all stakeholders.

Preservation of debtor's financial viability and expeditious return to growth and debt sustainability. All SDF procedures and actions should be designed with a view to preserving the financial situation of the sovereign under consideration and returning it to growth and debt sustainability as quickly as possible.

Predictability. SDF members should aim to design a collective, consistent process that would provide a flexible template for the discussion of sovereign crises. This template would remove the guesswork that currently exists in initiating an open dialogue on a particular sovereign crisis, but, as a non-statutory tool, it would be applied flexibly on a case-by-case basis.

Broad participation in crisis resolution. Unless otherwise agreed, all relevant stakeholders should be included in any crisis resolution program or debt treatment. Each creditor group's position with respect to the sovereign should be treated equitably and coherently. Cut-off dates on treatable debt may be considered to ensure that financing can continue to be provided to the debtor sovereign during discussions.

Enhanced data provision. The SDF staff would assist in the rapid exchange of economic and liability information among relevant parties following agreed protocols. SDF members could consider the creation of a standing debt registry to speed the identification of relevant interests in future debt discussions, although this function may be sufficiently fulfilled by the FSB's Legal Entity Identifier initiative.

Equal and concurrent information sharing. Information would be shared among SDF members on an equal and concurrent basis given the members' commitment to strict confidentiality.

Close consideration of financial-sector implications. The SDF would highlight the implications of any possible crisis resolution options for the financial sector. The euro-zone crisis has underscored again the close links between sovereign solvency and the banking system.

Voluntary stays of legal action. SDF member creditors could agree to refrain from taking legal action or advancing any pending lawsuits during consideration of a sovereign workout. This would be contingent on the sovereign's continued engagement in appropriate conduct, including good faith negotiations, consistent with membership in the SDF. SDF member creditors may also agree to coordinated rollovers in the spirit of the Vienna Initiative.¹

Changes in bond documentation. Consideration should be given to creating processes in which consensual revision of bond documentation can be effected, to the extent possible and necessary, to assist in the implementation of the SDF's work. This could include the insertion in bond documents of CACs and aggregation clauses, and by provisioning for the appointment of trustees to assist in the early formation of committees prior to any debt discussions.

Mediation. The SDF's members may wish to consider involving non-binding mediation and neutral professional mediators in its standard processes to speed its work and ensure balanced outcomes.

Retention of advisers. SDF members would be empowered to retain professional legal, economic and financial advisers to support their participation and representation in the SDF on an equitable basis. SDF members could consider cross-subsidizing such technical assistance.

AN SDF IS INCENTIVE COMPATIBLE

Both creditors and debtors would benefit from the creation of an SDF. Policy makers need greater

reassurance up front that crisis resolution can be undertaken in an orderly manner that minimizes collateral damage and delays. In the same fashion, investors need greater clarity on the norms, precedents and processes that will guide sovereign crisis resolution so that they can reasonably assess and price risk. An SDF could preserve institutional memory of past sovereign treatments and, on the basis of the insights these experiences provide, facilitate faster and smoother future sovereign crisis resolution by maintaining an organized and impartial venue for information discovery and negotiation.

Incentives for participation in an SDF stem directly from the benefits all classes of creditors and the distressed sovereign are likely to derive from an SDF's operations:

- **Debtor sovereigns.** Sovereigns facing financial crises should see the costs of exiting from these crises lowered by more rapid moves to resolve their distress, a greater focus on growth in their macro programs and faster returns to market access. The IMF (2006; 2012) and Buchheit (2011) have argued that the costs of sovereign workouts are generally reduced through earlier and faster action. This line of research needs to be pursued further.
- **Creditor sovereigns.** Following the introduction of the SDF, creditor sovereigns should see reduced demands for contributions to bailouts, as burdens are shared more evenly. They should also see contagion effects mitigated and predictability enhanced as informal precedents are set for future sovereign workouts.
- **Bondholders.** The SDF would provide bondholders with an opportunity to engage earlier in the sovereign crisis resolution process. Enhanced information on the sovereign, greater bondholder

¹ See <http://vienna-initiative.com/>.

voice in addressing sovereign crises and, hence, deeper commitment by bondholders to proposed solutions would be features of SDF-facilitated crisis workouts. Bondholders should see greater preservation of the value of their claims and an earlier return of the debtor sovereign to pre-crisis credit ratings.

- **Banks.** The benefits to banks would be similar to those created for bondholders. Participation in the SDF could also mitigate possible moral suasion on banks from creditor sovereigns and central banks in the resolution of sovereign crises.
- **International financial institutions.** More efficient use of IFI resources and enhanced dialogue with stakeholders would be a key result of the introduction of an SDF.

RECOMMENDATIONS FOR NEXT STEPS

Despite ongoing efforts to refine international macroeconomic policy making and financial sector regulation to prevent sovereign difficulties, periodic sovereign crises are likely to remain a feature of the global economy, both in the short term and over a longer horizon. We have a responsibility to reduce the depth, duration and cost of these crises. The following actions would be useful next steps:

- **Put sovereign crisis management at the core of the G20 agenda on an ongoing basis.** Efforts to improve our tool kit for handling sovereign crises will never reach a conclusion. Every crisis is different and continued work on preventing and resolving sovereign crises needs to feature prominently in the G20 agenda from 2014 onward. This would build effectively on the Russian presidency's efforts to

ensure discussion of public debt management in the 2013 G20 meetings.

- **Further research on the costs of sovereign crises.** The IMF (2006; 2012) has provided some indication that early and rapid resolution of sovereign distress generally minimizes the costs of such crises, but further work is needed to substantiate the sources and magnitudes of these costs. The IMF has the competent staff, data, information and resources to build on its earlier work.
- **Bring together a complementary menu of potential additions to our tool kit of responses to sovereign crises for the G20's consideration.** There are several work programs underway to expand our capacity to handle sovereign crises, including, inter alia, proposals for automatic maturity extensions on securitized debt, frameworks for voluntary rollovers and stays, arbitration and mediation processes, improved aggregation in CACs and, as discussed in this policy brief, the SDF. These proposals are mutually supportive and could be considered together in order to find elements across them that will allow G20 members to make incremental improvements to the international financial architecture.
- **Identify a small core of champions.** A small core of committed individuals is required to advance this work. Non-governmental actors, such as the Think 20, are ideally placed to identify and convene a set of sovereigns, multilaterals, financial market participants, lawyers and economists to flesh out the SDF and related concepts, and to advocate for their adoption. Proposals for an SDF and complementary efforts could be advanced by members of the International Monetary and Financial Committee, the FSB, the G20, the G24, the

OECD, the UN General Assembly and the IIF at the forthcoming regular meetings of these bodies — or through an invitation by finance ministers or central bank governors to an ad hoc stand-alone meeting of relevant parties.

- **Set target dates for action.** The G20 and its member states should be encouraged to set target dates for concerted and concrete action to improve their institutional methods for anticipating and responding to sovereign crises, building on work that has already taken place over the last five years. Target dates would galvanize efforts to improve our means of dealing with sovereign crises and would ensure that incremental progress is made prior to the next round of sovereign distress.

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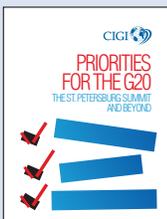
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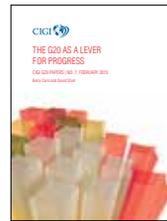
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PAPERS



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Five years after the onset of the global financial crisis, policy makers seemingly continue to believe that the severity of any crisis-led downturn can be divorced from its source. Credibility in new international regulatory frameworks must begin at home with a determination for monetary policies to work together.

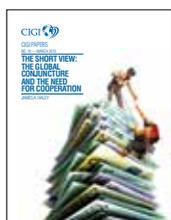


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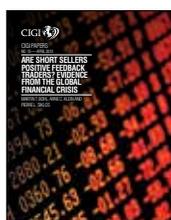


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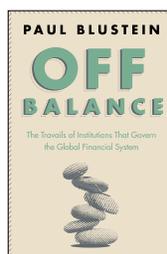
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