

FURTHER REFORM OF SOVEREIGN DEBT RESTRUCTURING: AN AGENDA FOR 2015

RICHARD GITLIN AND BRETT HOUSE

KEY POINTS

- Through improved contractual language and the reform of International Monetary Fund (IMF) processes, the international community made some important advances in 2014 to reduce the costs of sovereign debt restructuring for debtors and creditors. Little, however, has been done to reduce the inhibitions debtor countries face in dealing proactively with creditors to prevent and treat sovereign debt distress.
- Action to implement a Sovereign Debt Forum (SDF), revise the terms of the IMF's Flexible Credit Line (FCL), and improve borrow and lender codes of conduct could help address this reform lacuna.
- Additional practical reforms could also be undertaken to provide distressed sovereigns with more breathing room to address their problems and to make restructuring terms stick once they have been agreed.



RICHARD GITLIN

Richard Gitlin is a senior fellow at the Centre for International Governance Innovation and Chairman of Gitlin & Company.



BRETT HOUSE

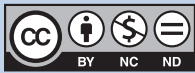
Brett House is a senior fellow at the Jeanne Sauvé Foundation and a visiting scholar at Massey College in the University of Toronto. He can be found on Twitter at @BrettEHouse.

INTRODUCTION

United Nations General Assembly (UNGA) Resolution 68/304 “Towards the establishment of a multilateral legal framework for sovereign debt restructuring processes” (UN 2014), passed by a split vote on September 9, 2014, expressed the will of many member states to move toward the development of a multilateral framework for sovereign debt restructuring. Coming a little over a decade after the rejection of the IMF’s Sovereign Debt Restructuring Mechanism (SDRM) proposal (Krueger 2001) in 2003, this UNGA resolution represents a substantial renewal of interest in statutory- and treaty-based approaches to treating distressed sovereign debt.

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AUTHORS' NOTE

This policy brief is based on remarks delivered at the “Frameworks for Sovereign Debt Restructuring” conference, organized by Joseph E. Stiglitz, New York, Columbia University, November 17, 2014.



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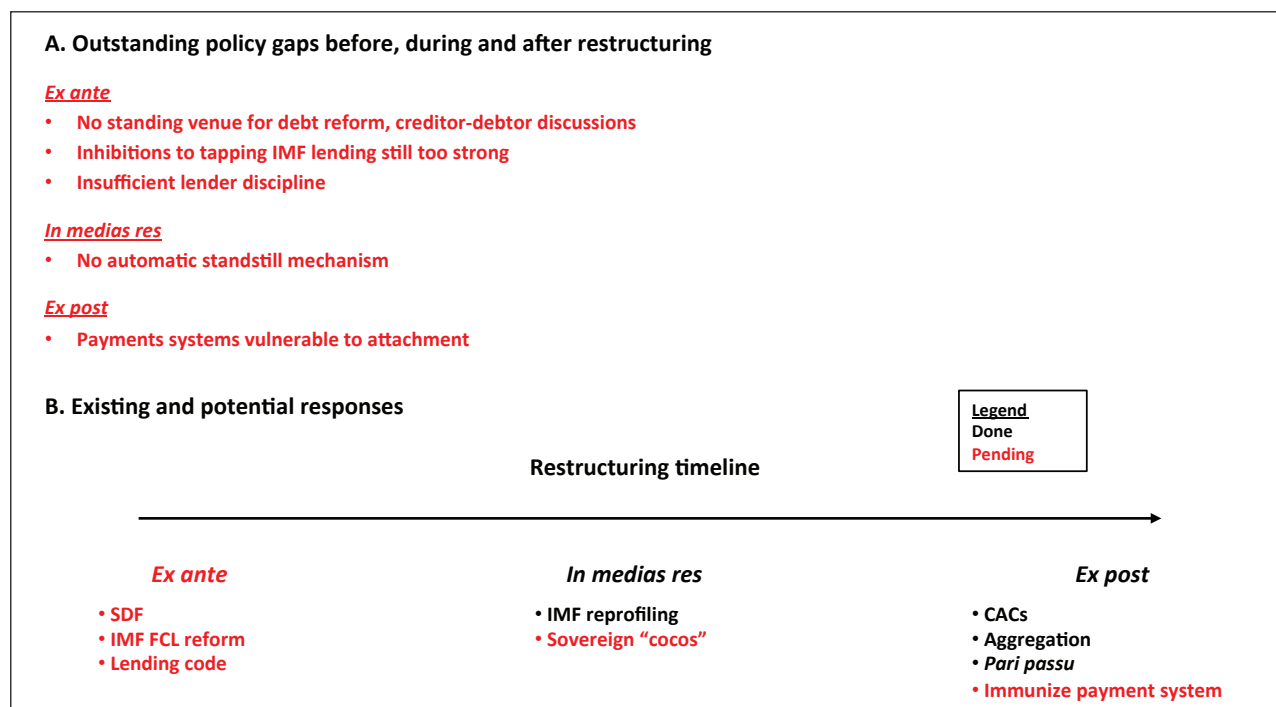
The resolution also exposed many of the same fault lines that doomed the SDRM: the major financial centres where most foreign-law external sovereign debt is issued by emerging and frontier economies did not support the resolution, even in its final, substantially diluted form. Some of these countries also expressed a preference for advancing this discussion at the IMF, rather than at the United Nations. This would represent a difficult impasse if treaty-based approaches were the only option available to improve further the modalities for dealing with sovereign debt problems, but they are not. A great deal more can be done through contractual and voluntary channels to make the treatment of distressed sovereign debt work better.

Parallel to any further developments in the United Nations and other intergovernmental processes, efforts to refine debt contracts and create voluntary means of assisting sovereigns when they encounter debt distress should be continued. If all the recommendations in the work program laid out below were implemented, substantial progress would be made without the rancor and possible failure that treaty negotiations could generate.

CONTEXT

Moved by the difficulties encountered in the 2012 Greek debt treatments, the continued pursuit of Argentina by creditors in the New York courts and the prospect of more sovereign financial distress in the face of high public debt burdens, the IMF staff usefully reopened the discussion of sovereign debt restructuring in April 2013 and, in so doing, substantially shifted the terms of the debate. After decades in which the presumption had been that sovereign debt restructuring should be costly in order to provide an incentive for proactive adjustment and a disincentive for gratuitous default, the IMF staff

FIGURE 1: COSTS OF SOVEREIGN DEBT RESTRUCTURING, POLICY GAPS AND PROPOSED RESPONSES



Source: Authors.

argued that the real problem is not that restructurings happen “too much, too soon,” but rather that they tend to be “too little, too late” (IMF 2013). The IMF board endorsement of the staff’s findings opened the way to subsequent staff papers during 2014 (IMF 2014a; 2014b) that have added the option of debt rescheduling or “reprofiling” to IMF-supported programs, even when exit sustainability remains questionable, foreshadowed the removal of the systemic waiver from decisions on exceptional access to IMF resources, endorsed improved contractual language on collective action clauses (CACs) following private-sector consultations and narrowed the implications of *pari passu* to exclude the ratable payment interpretation that has created problems for Argentina.

Discussions on the systemic waiver are likely to continue for some time at the IMF executive board (and will likely remain unconcluded as long as the euro zone faces

even a whiff of existential threat), but the rest of these reforms have been well received. The explicit option of reprofiling under IMF programs where sustainability is unclear adds board support to an approach that has already been implemented in cases such as Uruguay and the Dominican Republic’s debt treatments in the early 2000s. The new IMF- and International Capital Markets Association (ICMA)-endorsed contractual language (IMF 2014b; ICMA 2014), first featured in a new bond series issued by Kazakhstan in October 2014, has had no apparent effect on pricing. Mexico, one of the largest emerging-market borrowers, indicated in a November 2014 filing to the US Securities and Exchange Commission that it will also include the new language on CACs and *pari passu* in all future bonds it issues under New York law. In November 2014, Vietnam and Mexico both issued bonds with ICMA-consistent CACs and *pari passu* provisions, and Ethiopia followed in December. Greece and Belize, among others, have

already issued bonds that feature the new *pari passu* interpretation, but these came before the August 2014 release of ICMA’s standard clauses.

Over time, these initiatives will, together, have the effect of reducing the costs of sovereign debt restructuring (see Figure 1). The option to reprofile or reschedule debt obligations gives a distressed sovereign breathing room to deal with its problems in the midst of a crisis: it reduces the *in medias res* costs of restructuring by either preventing a restructuring from happening or allowing it to be organized in an orderly fashion pre-default with IMF support. Better CACs, narrowed *pari passu* provisions and aggregation reduce the *ex post* cost of restructuring by making the terms of a debt treatment stick more firmly once they have been agreed. But these provisions will only become powerful once enough new bonds bearing them replace existing outstanding debt. This will likely take more than a decade, since 40 percent of emerging market debt issued under New York law has residual maturities of 10 years or more, and the average residual maturity of all outstanding emerging market external debt is around seven years (IMF 2014b). Debtor countries could accelerate the rollover of outstanding debt stocks through liability management operations, but sovereigns have not yet indicated an interest in doing so.

Nevertheless, none of these developments directly address the problem of “too little, too late” that the IMF identified. They do not reduce the *ex ante* costs of restructuring. They do little to encourage sovereigns to deal with their debt problems proactively, they provide only a weak discipline on lender behaviour and they do not reduce the inhibitions country authorities face in seeking early, preventative assistance from the IMF. There are also clearly defined additional efforts that can be taken to further reduce the *in medias res* and *ex post*

costs of restructuring. These are issues that demand action.

NEXT STEPS AND RECOMMENDATIONS

This brief proposes a pragmatic action plan for the continued refinement of the contractual and voluntary approach to sovereign debt restructuring concurrent with any additional work on legal frameworks at the UN under UNGA Resolution 68/304 or elsewhere. This plan is focused on substantial efforts to reduce the *ex ante* costs of restructuring and to refine further existing efforts to curtail the *in medias res* and *ex post* costs of restructuring.

Make it easier for sovereign debtors to prevent and treat debt distress.

- Create an SDF, as proposed by Gitlin and House (2014), to provide a standing, independent venue in which creditors and debtors can meet on an ongoing basis to discuss incipient sovereign debt distress in a proactive fashion. An SDF would also ensure that there is a continuous research and reform process in place on sovereign debt issues so that improvement of the system is not allowed to go dormant again, as it did between 2003–2010. It would also provide for engagement in debt treatments by new sovereign creditors and the private sector in an upfront manner, rather than expecting these creditor classes to implement comparable treatment under existing conventional processes on terms that they have had little hand in crafting.
- Further reform the terms of the IMF’s FCL. Although the FCL is indeed more flexible than the Contingent Credit Line, its unloved and unused predecessor, countries still do not see enough value

in the FCL to create demand for its crisis-prevention and crisis-mitigation financing. Since the FCL's introduction in March 2009, only three countries — Colombia, Poland and Mexico — have sought (after much encouragement) and received arrangements under the FCL, despite market conditions that should have implied substantial interest in a well-designed, pre-emptive liquidity window. The last IMF review of the FCL's features took place in 2011. It is time to revisit the FCL's design in order to refine its qualification criteria and processes, improve the predictability of access to FCL resources, enhance the flexibility of its duration, increase the size of potential borrowing under the FCL and tweak the FCL's terms to make them less punitive.

- Frameworks — such as the Institute of International Finance's (IIF's) *Principles for Stable Capital Flows and Fair Debt Restructuring* (IIF 2012) and the United Nations Conference on Trade and Development's (UNCTAD's) "Principles on Promoting Responsible Sovereign Lending and Borrowing" (UNCTAD 2012) — need additional work to make them into stronger codes of conduct for lenders and borrowers. At present, the IIF principles are relatively long on expectations of debtors, but more parsimonious in their demands of creditors. Lenders also need a clearer code to guide future behaviour. In contrast, UNCTAD's principles are more symmetric in their design, but have received limited buy-in from private capital market participants. There needs to be a unified set of guiding principles that are both balanced in their design and widely endorsed.

Make debt standstills more automatic during crises.

- The revived proposal for two forms of state-contingent debt articulated by the Bank of Canada and Bank of England (Brooke et al. 2013) should be

acted upon. The first form, sovereign "cocos" (that is, contingent convertibles), consists of bonds that automatically extend their maturity upon realization of a pre-specified trigger linked to a liquidity crisis. The term is borrowed from corporate cocos, bonds that convert into equity when the firm's stock reaches a pre-specified strike price; clearly, the analogy is partial since there is no notion of equity in a sovereign context. Martin Brooke et al. (2013) propose tying activation of a sovereign bond's coco provisions to initiation of an IMF-supported program, but other triggers more removed from the sovereign's discretion would also be feasible, such as ratings downgrades, increased collateral requirements on a sovereign's debt or violation of a pre-specified floor on official foreign-exchange reserves.

- The second form, GDP-linked bonds, carry principal and interest provisions that vary with a country's GDP to preserve the sovereign's solvency in bad times and compensate creditors in good times. Debt service on these bonds could also be tied to global or regional growth, key commodity prices, global interest rate indices or other major aggregates that materially affect the financial health of the sovereign, but are independent of the government's discretionary actions.
- A major Group of Eight issuer — such as Canada or the United Kingdom — should step forward and begin issuing state-contingent debt. At present, the warrants attached as sweeteners to the 2005 Argentina and 2012 Greece debt exchanges are the major extant examples of state-contingent debt in action. Stronger economies need to issue such debt in order to make it more widely accepted.

- Worries that state-contingent debt cannot be priced by the market are misplaced. The market assigns prices to the Argentine and Greek warrants; modelling their price behaviour is straightforward. There is nothing involved in pricing a *coco* that does not already feature in pricing standard fixed-income instruments. While it is true that some asset managers would not immediately be able to invest in state-contingent debt under their existing investment mandates, it is also likely that these mandates would be modified as this debt becomes more ubiquitous and attractive.

Protect the integrity of clearing and payment systems.

- Belgium (Government of Belgium 2004) has passed legislation that protects the Euroclear payment system from attachment threats and the spectre of paying agents falling into contempt situations such as those raised by the *NML Capital Limited v. Argentina* cases in the New York courts. Luxembourg provides similar protections for Clearstream.
- In the early 2000s, the United Kingdom (Government of the United Kingdom 2011) passed legislation that offered protection under English law to the 40-odd heavily indebted poor countries that saw most of their external debt written off by bilateral creditors, the IMF, the World Bank, the African Development Bank and the Inter-American Development Bank under debt-relief programs that began in 1996.
- Action should be launched to add such immunities to payment systems under New York law and to broaden these immunities under English and other European jurisdictions.

AN AGENDA FOR ACTION

A great deal more can be done to enhance and refine the prevailing contractual and voluntary approach to sovereign debt restructuring. Building on the improvements to contractual provisions widely endorsed in 2014 and the IMF’s move to support reprofiling in cases where debt sustainability cannot be ensured, the pragmatic proposals outlined above could be implemented in the coming years to reduce further the costs of treating distressed sovereign debt. Action on this work program should be at the core of the international agenda in 2015 — both in Europe and in fulfillment of the Group of Twenty’s commitment to further engagement or progress on sovereign debt restructuring (Group of Twenty 2014).

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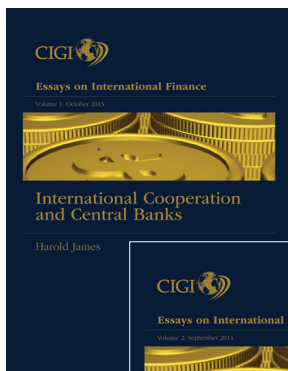
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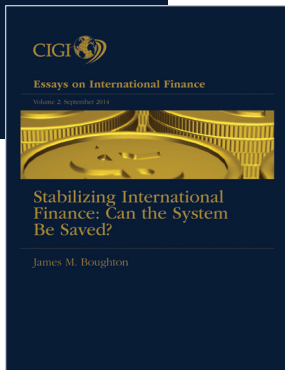
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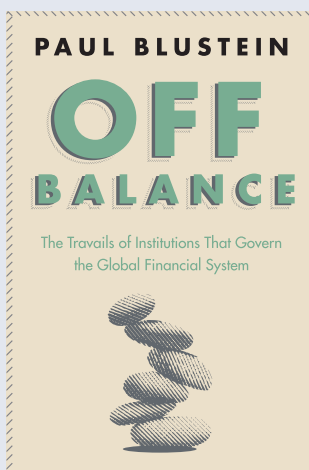
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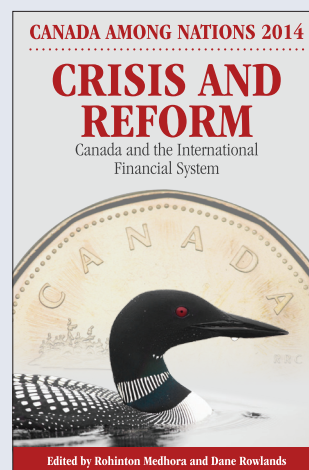
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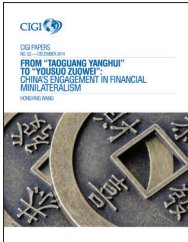
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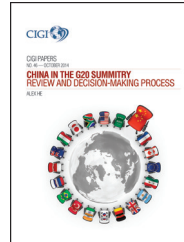
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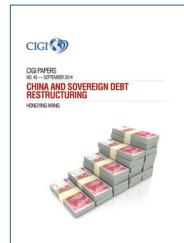
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