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SOVEREIGN DEBT RESTRUCTURING
OLD DEBATES, NEW CHALLENGES

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ACRONYMS

CACs	collective action clauses
DIP	debtor-in-possession
ECB	European Central Bank
FfDO	UN Financing for Development Office
IIF	Institute of International Finance
IMF	International Monetary Fund
NPV	net present value
OMT	Outright Monetary Transactions
SDF	Sovereign Debt Forum
SDRM	Sovereign Debt Restructuring Mechanism

EXECUTIVE SUMMARY

Ten years ago, in the wake of the Asian financial crisis and subsequent Argentine default, the international community debated how to best promote the timely, effective restructuring of sovereign debt. The debate then focused largely on the relative merits of a so-called statutory approach for sovereign restructurings, with features of domestic bankruptcy regimes, versus the voluntary use of contractual terms designed to facilitate restructurings. At the time, the statutory approach did not have the support necessary to move from proposal to policy and efforts to improve the framework of sovereign debt restructuring rested on the contractual approach.

Today, the issue of sovereign debt restructuring is again on the international policy agenda and the debate is once more framed in terms of statutory versus contractual approaches. This paper is intended as a guide to the issues. It first reviews the underlying problems that impede timely sovereign debt restructurings and the tools that have been developed to address them. It then identifies the policy responses that were proposed and discussed a decade ago in response to the financial crises that were sweeping through the global economy. Some elements of these "old debates" have declined in importance given developments over the past decade. Other elements of those earlier discussions, however, remain relevant in the context of the "new challenges" that confront the international community, which include concerns regarding the sustainability of Greece's debt in an environment of possible deflation and the potential effects that ongoing litigation against Argentina could have on the current framework for sovereign debt restructuring.

As was the case a decade ago, the statutory approach likely lacks the support needed for implementation. Nevertheless, efforts to enhance the framework for sovereign debt restructuring should continue, given the large adjustment challenges that still cloud global economic prospects five years after the trough of the worst worldwide downturn since the Great Depression. This paper suggests three areas for further analysis. The first is expanding the scope of contractual clauses that can help facilitate restructurings. The second is accounting, tax and regulatory frameworks; the goal would be to identify possible changes that would remove obstacles to timely, orderly restructurings. Improving the process by which debt restructuring negotiations are conducted is the final area in which efforts can be made to improve the restructuring process. A voluntary Sovereign Debt Forum (SDF) that promotes the exchange of information and provides a repository for best practice could accelerate negotiations, leading to earlier access to private markets and a return to growth.

INTRODUCTION

After a long hiatus, the Greek debt crisis and ongoing litigation against Argentina have reanimated the debate on sovereign debt restructuring that raged a decade or more ago. Two years after the Greek restructuring, doubts remain about the sustainability of the adjustment effort required under the terms of the international support package, fuelling concerns that a further restructuring will be required. At the same time, Argentina's long-standing legal dispute with "hold-out" investors who did not participate in past debt restructurings, which led to a judgment against it, may, it is feared, undermine the process of voluntary or market-based restructurings that has developed over the past two decades If Argentina is unsuccessful in its appeal to the US Supreme Court, such restructurings could be more difficult to secure, since the expected returns from holding out would be increased.

The issue of sovereign debt restructuring had fallen off the international policy agenda a decade ago, as concerns of a systemic threat to the global financial system dissipated in the benign conditions that prevailed before the global financial and economic crisis. In this respect, the so-called "Great Moderation" may have lulled markets and policy makers into complacency about the risks of a new wave of sovereign debt crises and, absent the discipline of financial markets, allowed excessive accumulation of private sector debts. Once the crisis struck, however, bank failures led to the transfer of debt burdens from private to public sector balance sheets, while fiscal deficits widened everywhere as economies weakened.

This confluence of factors leading to higher debt burdens and increased risks of sovereign debt difficulties is not unique. The seminal work of Carmen Reinhart and Kenneth Rogoff (2009) documents a pattern of asset and real estate bubbles and excessive debt accumulation. Viewed through this long-term perspective, the series of international financial crises that motivated international efforts to reform the international financial architecture a decade ago are, like the global financial crisis, simply additional observations in a long history of debt and default. Moreover, this history underscores the importance of improving the framework for sovereign debt restructuring.

Ten years ago, debate on this issue was marked by a cleavage between those prepared to support so-called "voluntary" approaches, in which bondholders would accept contractual modifications that facilitated restructuring, and those who supported the more formal, statutory approach represented by the Sovereign Debt Restructuring Mechanism (SDRM) — as developed by the International Monetary Fund (IMF) under then First Deputy Managing Director Anne Krueger. Policy makers decided to abandon statutory approaches in the wake of concerted efforts to include collective action clauses (CACs) in new bond issues of key emerging market

economies. Such clauses have since become part of the de facto "boilerplate" of bonds issued under New York law.[1]

In some respects, current discussions on restructuring sovereign debt mirror that earlier debate. Then, as now, attention focused on the relative merits of constructing a formal legal framework for sovereign debt restructuring, analogous to domestic bankruptcy regimes, versus an alternative approach based on the development and adoption of contractual terms for bond documentation that would help facilitate the restructuring of sovereign debt. A key consideration in this regard is the political will of members of the international financial community to consider formal legal approaches. The necessary support to proceed was lacking a decade ago; it likely does not exist today. That said, key insights were gleaned from these earlier discussions and important progress was made in improving the framework for sovereign debt restructuring through the incorporation of contractual terms designed to facilitate the restructuring of individual bond issues.

Similarly, there are non-controversial, incremental steps that can be taken today to further strengthen debt-restructuring efforts. This paper proposes three possible initiatives. First, drawing on the successful experience with CACs, efforts to secure agreement on contractual "best practice" for standstill and aggregation clauses should be pursued to further enrich the voluntary approach to sovereign debt restructuring. Second, a review of regulatory, tax and accounting factors could identify provisions that impede restructurings. Such a review might result in the harvesting of "low-hanging fruit" by way of measures that might be implemented quickly and with little controversy. The third possible initiative is the development of an SDF, which can be viewed as an attempt to enhance the efficiency of voluntary debt-restructuring negotiations. An SDF could either demonstrate the potential benefits of a statutory approach or confirm the views of those who argue that such an approach is not needed. These relatively modest initiatives could help address key impediments to timely, orderly restructurings, even as the debate on broader reforms continues.

COORDINATION COSTS AND POLICY RESPONSES

In the wake of the financial crises that erupted in Asia in 1997-1998 and subsequently spread to other regions, international attention turned to how best to facilitate the restructuring of sovereign debt. Initially, efforts focused on the problem of securing financing for countries confronting severe balance-of-payments crises, as private capital flows to distressed sovereigns came to a sudden stop or were reversed. In time, however, the debate broadened beyond the problem of illiquidity to include the issue of insolvency and the debt writedowns that default may entail. In part, this shift in emphasis reflected the fact that expectations of medium-term growth for some countries were revised down, impairing debt-servicing capacity; in part, because some governments assumed private sector debts during the crisis, increasing public debt-to-GDP ratios.

THE PROBLEM OF DEADWEIGHT COSTS

The impact of these crises and the potential disruption they posed to global financial markets energized efforts to augment the international adjustment tool kit, in cases where debt burdens were viewed as unsustainable. The concern was that with a high debt burden, incentives to pursue sound macroeconomic policies could be distorted, as the benefits of the politically difficult adjustment measures needed to restore balance of payments accrue disproportionately to foreign creditors, while the costs fall largely on domestic residents. In these circumstances, governments might be tempted to adopt measures to evade the costs of debt servicing and introduce beggar-thy-neighbour policies. Such policies pose potential spillover effects to neighbouring countries (see Fried and Haley 2010). Attempts to enforce unsustainable debt burdens could have adverse effects on both the indebted country and the global economy more broadly. If the costs of sovereign default are too low, however, default and restructurings could become too frequent. The result could be a collapse in international lending.

The challenge was to strike a balance between the need for restructurings in cases where debt burdens are intolerable, on the one hand, and the need to enforce payments discipline — to preserve the bonding role of debt — on the other hand. At the same time, there was a perception that the status quo approach to sovereign debt restructuring unnecessarily increased costs borne by all parties. The following points are discussed more fully below:

- creditors are harmed, as asset values are affected by continuing uncertainty and the possible adoption of unsound policies;
- debtor countries suffer, as growth falls, unemployment rises and support for sensible, sound economic policies erodes; and
- the IMF is adversely affected, as it is less able to assist its members in distress by striking a judicious balance between providing them financing and the adjustment policies its members must undertake to close balance-of-payments imbalances.

Consistent with these effects, efforts to improve the sovereign debt restructuring process were intended to return the country to a sustainable growth path sooner and support the market for sovereign debt. Achieving these

1 Such clauses have long been a standard feature of English-law bonds issued in London.

objectives would reduce deadweight losses, which were seen to result stem two sources.

CREDITOR COORDINATION PROBLEMS

The first source of deadweight losses is creditor coordination problems, which were thought to pose a major obstacle to the restructuring process. The nature of this problem has evolved over time. In the 1980s, when foreign bank lending constituted the bulk of private claims on sovereigns, bank steering committees were the key negotiating body. Bonded debt represented a relatively small proportion of outstanding sovereign debt and was therefore able to escape unscathed from restructurings. By the 1990s, however, bonded debt represented the bulk of claims on sovereigns, as commercial banks were replaced with bondholders.[2]

This evolution in the structure of outstanding claims led to concerns that difficult, protracted restructuring negotiations would increase deadweight losses. In the case of bank debt rescheduling and restructuring in the 1980s, lead syndicate banks frequently had an incentive to buy out claims of smaller, recalcitrant participants, internalizing potential coordination problems, while large banks sought to preserve their reputational capital and client relationships by participating in concerted lending and efforts to resolve debt problems. As a result, negotiations involved a limited (though frequently large) number of creditor banks. In contrast, sovereign debt restructurings in the 1990s involved a much larger, more heterogeneous creditor community. The diverse composition of the bondholder community and the nature of covenants embedded in bonds issued under New York law requiring unanimity to amend key clauses would, it was thought, impede the timely, orderly restructuring of sovereign debt. The specific concern was the threat of opportunistic behaviour — or the potential for specialized funds, referred pejoratively to as "vulture" funds, to block a restructuring broadly acceptable to most creditors in order to extract higher payouts.

INCENTIVES FOR RENEGOTIATION

The second set of costs motivating efforts to develop a better framework for sovereign debt restructuring stems from the dynamic nature of international lending. That is, the manner in which crises are resolved may affect creditor and debtor behaviour going forward and thereby influence the frequency and severity of future crises. The role of the IMF, as guardian of international monetary and financial stability, is critical in this regard. Too easy access to liquidity could foster moral hazard, as creditors engage in imprudent risk-taking and borrowers fail to self-insure or follow sound policy frameworks.[3] The problem confronting the IMF is that debt restructurings entail a risk of contagion that can impart a negative shock to other countries, either through direct trade and financial linkages or indirectly through higher risk *premia*. From the sovereign's perspective, meanwhile, the debt-restructuring negotiations may involve a loss of access to capital markets and, as a result, an immediate draconian compression of expenditures. These effects can come together to create a situation in which it is extremely difficult for the IMF to deny additional financing if the authorities are prepared to commit to a program of policy measures sufficiently robust to constitute "adequate safeguards" of repayment, even if there are very large implementation challenges and vexing questions regarding the sustainability of the program.

Unfortunately, support for such programs may be inconsistent with the IMF's fundamental objective of assisting its members to strike a judicious balance between financing and adjustment. The reason for this result is that, given the increased size of capital account crises, the burden of adjustment placed on the indebted country may be too great. If the reduction in domestic absorption (the sum of private consumption, investment and government expenditures) needed to restore sustainability is too high, members may be tempted to "defect" from the cooperative equilibrium of sound policies and adopt measures "destructive of national and international prosperity"

2 The evolution in the role of bonded debt neatly illustrates the point that capital structure is not independent of the underlying legal and institutional structures. Bonded debt increased in importance in the 1990s because it was thought to be immune from restructuring, based on earlier experience. Such expectations were subsequently frustrated, as in the case of Pakistan, while more recent innovations with respect to the contracting technology, including the use of exit consents, greatly assuaged creditor coordination problems among a highly defused and heterogeneous bondholder community.

3 In the domestic context, these considerations are addressed by Walter Bagehot's (1873, chapter 7) admonition that central banks should provide a lender-of-last-resort facility that lends freely on good collateral and charges a penalty interest rate. This guidance is less applicable at the international level, since the IMF's capacity to lend is strictly limited, as is its ability to take collateral.

that the IMF was created to prevent (see IMF 1945, Article I [v]).[4]

At the same time, IMF financing can have unintended consequences because of its preferred creditor status, or the convention that the IMF is repaid in full before private creditors receive payments. In particular, while IMF programs are designed to prevent a suspension of payments and disorderly default, when a program fails to restore confidence and quell capital flight and the member subsequently defaults, IMF assistance can magnify losses to remaining private creditors. This outcome reflects the fact that, since the IMF is repaid in full, private creditors must share a smaller pool of resources available for debt service. As a result, there is a risk that the announcement of negotiations leading to an IMF program may incite private creditors to flee in order to avoid possible losses.

POLICY RESPONSES

In view of these problems, efforts were made in the wake of the Asian financial crisis to create incentives for private sector creditors to engage in the crisis resolution process. Greater private sector involvement would, it was hoped, reduce the stresses on IMF resources and reduce deadweight losses.

ACCESS LIMITS

Attention initially focused on the establishment of strict access limits on the size of IMF support packages, with clearly defined conditions for exceptional access.[5] The intent was to discipline behaviour on the part of sovereign borrowers and their creditors by influencing expectations of the amount of IMF assistance that would be forthcoming in the event of balance-of-payments difficulties. Some progress was made in clarifying the conditions under which exceptional access would be provided,[6] but the size of the financial challenges faced by members, and the perceived risks associated with a disruptive suspension of payments, led to a situation in which exceptional access was the norm and not the exception.

Regardless of how desirable strict limits are *ex ante*, the potential disruption associated with their enforcement renders them incredible, or dynamically inconsistent, *ex post*.[7] Absent a framework that contains the fallout from limiting financing, attempts to impose strengthened access limits and constrain discretion are not credible and will not, therefore, affect behaviour. Promoting timely, orderly and *voluntary* restructurings through adherence to limits to official sector financing requires a credible threat of *involuntary* solutions — in other words, a framework to promote the efficient recontracting of debt.

4 The IMF was designed to assist members dealing with balance-of-payments problems in the context of the general adoption of capital controls; a strict reading of Article VI of the IMF Articles of Agreement would preclude the IMF from assisting members facing capital account crises. The widespread use of capital controls in the Bretton Woods era ensured that balance-of-payments difficulties were limited to differences in national saving and investment rates, typically a few percentage points of GDP. In these circumstances, IMF-supported programs that spread the adjustment process over time, smoothing the impact of fiscal or other policy measures designed to compress domestic absorption, facilitated a judicious balancing of financing and adjustment and encouraged members to eschew policies that would have negative spillovers to the global economy. This felicitous outcome was possible because the IMF typically had the resources needed to fill balance-of-payments gaps, but by the early 1990s, with the elimination of capital controls and the development of highly integrated global capital markets, the nature of these gaps changed. Such problems now quickly evolve into financial crises analogous to bank runs, as foreign and domestic investors attempt to convert asset stocks from domestic to foreign assets. These capital account crises are typically much larger (reflecting the conversion of asset stocks) and unfold over a much shorter time than the current account problems of the Bretton Woods era. Moreover, because private capital flows dwarf the resources of the IMF, the adjustment burden borne by crisis-afflicted countries is correspondingly higher. This may account for the perception among some members that the IMF is less effective in assisting its members strike a judicious balance between financing and adjustment.

5 Although these measures are frequently cast as efforts to "bail in" private sector creditors, this is both an unflattering and potentially misleading characterization. Contrary to the impression that the objective is to enforce some notion of "fair" burden sharing, the goal of strict access limits is to prevent official sector resources from shielding private creditors from the risks they assumed when contracting with sovereign borrowers. In other words, the intent is to enhance market efficiency; particularly the efficient allocation of capital and risk bearing. An analogous approach is to establish an *ex ante* threshold on debt accumulation. Below the threshold (for example, the 60 percent of GDP level set by the Maastricht Treaty), the country would be eligible for emergency liquidity assistance. Above that level, countries would be ineligible for IMF assistance in the event that the sovereign borrower experiences debt-servicing difficulties. The threshold provides an automatic "brake" on debt accumulation, since the closer a country gets to the threshold, the more private creditors will start to factor in the costs of a possible disruption to debt servicing and the potential "haircut" from a restructuring. Costs to the borrower would rise, and this would reduce the demand for borrowing. In these circumstances, the restructuring process would be characterized by bargaining between the sovereign borrower and its private creditors, without the added complication of efforts to "game" the official sector into providing support. In this respect, a credible, binding *ex ante* constraint aligns incentives and accelerates the restructuring process. The operative word here is credible. See Bucheit et al. (2013).

6 For a discussion of these efforts and an evaluation of the implementation of exceptional access criteria, see Schadler (2013).

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

The recognition that limiting official sector financing was intrinsically tied to the costs of financial disruption gave added impetus to efforts to make the debt restructuring process more effective. In some respects, the goal was to create an environment in which sovereign borrowers and their private sector creditors could come together to renegotiate claims. On this, there was broad consensus. The debate revolved around the question of whether a formal statutory (treaty-based) framework was required or whether the same outcome could be achieved through other means.

FRAMEWORK FOR STRUCTURED BARGAINING

The key requirement is that there is a framework for structured bargaining that brings the parties together and facilitates negotiation. The domestic analogue is restructurings done in the "shadow of the courthouse," in which debtors and creditors know that they can either come to a voluntary solution or litigate. Litigation entails deadweight losses in the form of legal fees and the time involved.[8] The more resources allocated to legal costs, the less money available for division between the creditors and the debtor. However, there are more consequential costs associated with increased uncertainty that clouds the firm's future prospects and undermines the franchise value of the firm, as customers looking for long-term relationships are lost and critical suppliers limit exposures. The threat of an involuntary solution "through the courthouse" creates the incentive to do a voluntary deal more quickly, thereby preserving the size of the pie to be divided. Moreover, the rules provided by the bankruptcy regime help anchor expectations of the likely outcome of the "involuntary" (litigation) approach. As a result, less time is lost in unproductive negotiations that lead to a dissipation of asset values.[9]

In this respect, the key objective of an efficient bankruptcy regime is to assuage coordination problems and promote wealth maximization by:

- **limiting asset seizures and creditor runs** in the restructuring process and preserving asset values through stays on litigation and debtor-in-possession (DIP) financing;
- **containing opportunistic behaviour** designed to disrupt restructurings broadly acceptable to the (super) majority of creditors through the use of DIP financing and cram down provisions; and
- **debt discharge, or reduction of claims,** to avoid the perverse incentives created by a debt overhang.

At the domestic level, the first two objectives are promoted through stays on creditor litigation for debtors that have sought the protection of the bankruptcy court; DIP financing, in which new lending to debtors under the protection of the bankruptcy court enjoys a priority of claim over pre-existing creditors; and cram down provisions that enforce a restructuring broadly acceptable to all creditors.

STAYS ON LITIGATION

Analytically, the role of a stay on litigation (or "standstill") is to help rule out possible bad outcomes in an environment in which expectations play a critical role in determining where the economy is likely to settle. The story here is similar to the use of deposit insurance or, alternatively, "bank holidays" to prevent destructive panicked runs by depositors (see Diamond and Dybvic 1983). Absent such measures, a panic among depositors could deplete cash reserves, forcing the fire sale of less liquid assets, and result in the liquidation of the bank, with losses to depositors who were unable to flee. In the context of a sovereign debt crisis, foreign creditors trigger a run on the fixed stock of foreign exchange reserves at the central bank.[10] With the stock of such claims typically far in excess of actual reserve holdings, there is a problem of ill-defined property rights over foreign exchange reserves and a common pool problem that encourages creditors to attempt to exchange the domestic-currency-denominated asset for the dollar-denominated asset. Not all creditors will succeed in making this exchange, so there is an incentive to move first. But if all creditors think alike, all will seek to exchange their claims, exhausting the foreign exchange reserves and precipitating a crisis. And, just as the deposit outflow exceeds assets that can be liquidated to meet the demand for liquidity in a bank run, resulting in the fire sale of assets that threatens solvency, the pace of capital flight and the depletion of foreign exchange reserves exceeds the rate

8 The process can be viewed in terms of a bargaining game in which the object is to divide a reward that shrinks over time. The longer that a partition acceptable to both sides is delayed, the smaller the reward to be shared. Analogously, the longer that a debt restructuring is deferred, the higher the litigation costs and the greater the losses measured in terms of forgone output and interest income, which flow from a normalization of debt servicing.

9 Well-developed bankruptcy regimes can be viewed as reducing the variance bounds around potential outcomes. The legal framework does not eliminate uncertainty associated with possible outcomes, of course, but reduces the range of likely outcomes. It is this feature that guides restructurings in the shadow of the courthouse.

10 It is important in this regard to distinguish between domestic and foreign debt. Domestic debt carries less risk because the central bank can help address the adjustment challenge through recourse to the inflation tax. Foreign debt is potentially far more problematic, given that it carries the risk of currency mismatches: debt is denominated in one currency (US dollar), while the resources from which the debt is serviced are denominated in the domestic currency. In the event of a currency crisis that leads to the depreciation of the domestic currency in terms of the dollar, the mismatch between the two results in an effective increase in debt. In this scenario, a liquidity crisis that triggers currency depreciation could quickly cascade into a solvency problem as the domestic currency value of the debt burden is increased and the economy is squeezed by debt-servicing efforts.

at which traditional adjustment measures generate foreign exchange for debt service.

At the international level, a standstill that precludes the panicked run and allows for the orderly restructuring of claims could help prevent this disruptive scenario. Moreover, given the deadweight losses associated with an extended limbo period and the potential for governments to defect from sound policy frameworks, in the context of sovereign debt difficulties there is an overarching need to focus on growth; in this respect, a well-designed standstill agreement would give the sovereign time to introduce policies that "grow the pie." There are still significant implementation challenges to overcome. Perhaps most important is the question of who, or what conditions, triggers the implementation of the standstill. Safeguards would be required to ensure that the standstill is used to preserve asset values and support growth and to minimize possible distortions. Such safeguards are needed to preserve inter-creditor equity between domestic and foreign creditors to ensure that domestic residents, who may have preferential access to critical information, are not allowed to flee, leaving foreign investors to bear a disproportionate burden of a possible debt restructuring.

DIP FINANCING

Most domestic bankruptcy regimes combine a court-sanctioned stay on proceedings with DIP financing, which accords priority to new lending to a firm undergoing a court-supervised restructuring. In a sense, the quid pro quo to existing creditors of the stay is the breathing space provided to the debtor to reorganize and propose an orderly restructuring that helps support asset values; similarly, while new lending under DIP financing enjoys priority, it helps preserve the asset values of all creditors by keeping the firm in operation, preserving the relationship capital of the firm as a "going concern," and allowing the introduction of measures to return the operation to profitability.

In some respects, IMF assistance can be thought of as the analogue of DIP financing for sovereigns, as such support is extended only if the member is already confronting severe financial difficulties; moreover, while DIP financing keeps the firm operating as a going concern and avoids the disruption associated with liquidation — to the benefit of other creditors — IMF support is intended to stabilize the situation to the benefit of the sovereign borrower and its creditors.[11] IMF support differs from DIP financing in one critical respect: when a firm fails to meet its financial obligations, creditors can petition the court for a bankruptcy order, with which existing equity holders face losses and management is replaced. There are no parallels with respect to IMF programs.

CRAM DOWN PROVISIONS

While a framework for structured bargaining may result in a restructuring broadly acceptable to most creditors, it is unlikely to produce agreements acceptable to all creditors. Domestic bankruptcy regimes typically have provisions under which courts can enforce, or "cram down," the agreement on all creditors, where a supermajority of creditors approves the proposed restructuring. Such provisions limit the ability of individual creditors or groups of creditors to block a restructuring arrangement in order to extract preferential terms. Notwithstanding the success of past efforts to introduce CACs in new bond issues, additional work is required to replicate the cram down provisions in domestic bankruptcy frameworks. In particular, if not backed by a more formal mechanism that allows for the aggregation and restructuring of all outstanding debt, CACs would remain a necessary but insufficient means to prevent a small group of creditors from blocking a restructuring that is acceptable to most. This result reflects the fact that, while CACs can facilitate a restructuring of a particular bond series, bondholders may not be prepared to accept a restructuring offer in the absence of assurances that other creditors will also be making similar sacrifices. Some mechanism that limits the returns from opportunistic behaviour in the face of this so-called aggregation problem may be necessary to achieve an outcome that makes all stakeholders better off.

At the same time, while important progress has been achieved in incorporating CACs, a purely contractual approach has limitations. CACs can help resolve creditor coordination problems, but are a poor substitute for more formal bankruptcy regimes. Bankruptcy regimes deal with externalities, societal distributional problems and broad equity concerns regarding a wide range of stakeholders, all of which are the domain of public policy, not private interests. As Anna Gelpern (2013a) has argued, it is not possible to impose these broader public policy objectives on individual contractual terms, however worthy. Recent litigation surrounding the use and interpretation of *pari passu* clauses in Argentine bonds is a case in point: while individual creditors have an interest in enforcing such covenants, their enforcement, as currently subject to judicial interpretation, could undermine the principle of sovereign immunity and impair the ability of severely distressed sovereign borrowers to secure restructuring

11 Conceptually, the provision of a lender of "first resort" facility could serve to preclude the bad equilibrium by removing the threat of a shortage of foreign exchange reserves. See Cohen and Portes (2006). The Outright Monetary Transactions (OMT) unveiled by the European Central Bank (ECB) are an example. The mere announcement of the OMT has, indeed, calmed markets without the need to follow through with bond buying on secondary markets. In this respect, however, the mechanism is untested, and it is unclear how markets would react if a euro member country requested activation.

agreements broadly acceptable to a supermajority of creditors.[12]

DEBT DISCHARGE

The third element of efficient bankruptcy regimes — debt discharge, or a reduction in the value of outstanding claims — is more problematic. Analytically, some reduction in the value of claims may be required to avoid distorting incentives to follow sound policies. At the domestic level, discharge is determined by a disinterested bankruptcy judge who assesses the debtor's ability to repay, and balances creditors' claims with those of a wide group of stakeholders. At the international level, the analogue of discharge is determined by bargaining between the creditors and the debtor over the size of prospective haircuts, or a reduction in the net present value (NPV) of outstanding claims. The process of restructuring sovereign debt can be protracted, highly contentious and potentially disruptive because of disputes over the sovereign's *willingness* to repay, in addition to uncertainty with respect to *ability* to repay. These concerns underscore the potential signalling role for the IMF to indicate when a sovereign is making good-faith efforts to negotiate and adopting policies that enhance debt-service capacity and preserve asset values (grow the pie) to the mutual benefit of creditors and the country itself.

While the IMF can, in theory, play the role of disinterested third party providing advice, as crises have grown and IMF programs have increased in size, new concerns have emerged that the IMF is less able to provide unbiased estimates of the feasible adjustment effort that heavily indebted borrowers can sustain. In this respect, some argue that the IMF's debt sustainability analysis has changed over time and the factors that have influenced the IMF's assessment are less transparent.[13]

Uncertainty with respect to the fundamental nature of the debt problem — whether it is liquidity or solvency — and the capacity of creditors to absorb losses associated with asset writedowns and/or reduced income streams is also an important consideration. The resolution of the Latin American debt crisis in the 1980s, for example, might have been delayed by changing perceptions of the situation. Initially, the problem may have been viewed as a temporary lack of liquidity, for which rescheduling and new money was an appropriate response; the problem of insolvency was only recognized over time. More likely, however, was the realization that it would take time for commercial bank creditors to build the reserves necessary to contemplate debt reduction — leading to the rule that the speed of resolution is determined by the speed at which creditors can absorb losses.[14]

The potential for the IMF's preferred creditor status to subordinate private claims heightens the effects of uncertainty. In hindsight, it is now clear that the sovereign debt restructurings of the 1980s were conducted with modestly sized programs, in which the IMF played a "catalytic" role by monitoring countries' policies and mobilization of debt rollovers. With the debt crisis initially viewed as a temporary liquidity problem, the IMF was, in effect, a bonding mechanism to enforce highly indebted countries' commitments to adopt structural reforms. These reforms gave commercial bank creditors the confidence to roll over, reschedule and provide new money as required to bridge the stronger growth that structural reforms would deliver. Higher growth would reduce debt-to-GDP ratios by growing the denominator. More recent experience with capital account crises has featured large IMF financial packages that have allowed other creditors to liquidate their investments without a haircut. Such crises are larger in magnitude and unfold over a much shorter period of time, compressing greater adjustment into a smaller time frame. This raises the potential costs of crises and, from the IMF's perspective, underscores the need to move quickly to restore market confidence to stem capital outflows. The problem is that while some investors escape unscathed, increased official sector money magnifies the risk of subordination to the private creditors that remain.

OLD DEBATES

The SDRM was proposed a decade ago to create a framework for structured bargaining with respect to sovereign debt so that the IMF could better assist

12 Creditors that would otherwise be prepared to agree to a restructuring conditional on supermajority approval would be reluctant to participate if there were a significant risk that so-called "holdouts" could use a *pari passu* clause to recover full value on their initial investments.

13 In fairness to the IMF, given market sensitivities and the nature of the relationship between the IMF and its members, the goal of timely, concerted action to restore confidence could be inconsistent with the goal of transparency. In this respect, the nature of debt problems has evolved considerably since the 1980s. Earlier debt crises unfolded in an environment of limited capital mobility and controls that largely limited balance-of-payments difficulties to problems of the current account, or gaps between national savings and investment rates — typically a few percentage points of GDP. IMF resources were provided under the terms of "financial programming," as determined by the monetary approach to the balance of payments. In contrast, since the early 1990s, international financial crises have emerged from the capital account. While such crises can be resolved by early action to restore market confidence to stem capital outflows, to be effective, such measures must affect market expectations, which are not observed directly.

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

members with unsustainable debt burdens.[15] It would have formal legal status embedded in treaty obligations (the IMF's Articles of Agreement), but the need for a formal mechanism was hotly debated. On the one hand, sovereign borrowers can impose a de facto standstill on creditor runs by *force majeure*; while creditors can secure judgments against sovereign respondents, the problem from the creditor's perspective is enforcement. In this regard, the doctrine of sovereign immunity remains a significant barrier to the successful execution of judgments against recalcitrant sovereign borrowers.[16]

On the other hand, the ability of sovereign borrowers to *unilaterally* impose a suspension of payments serves to underscore the possible benefit of an internationally recognized stay on litigation. The objective of such a stay would be to differentiate countries that are using the payments standstill as breathing space in which to implement sound policies to facilitate adjustment, preserve asset values and negotiate in good faith with their creditors from countries that are merely seeking to avoid payments discipline. Lending into arrears, under which the IMF provides financial assistance to a country that has invoked an internationally sanctioned standstill, can be used to support good behaviour and avoid an excessive compression of imports that could result in a loss of production that would reduce debt-servicing capacity. In much the same way, DIP financing allows a firm in bankruptcy protection to continue as going concern, preserving the value of the firm to its shareholders and other stakeholders during the restructuring process (see Bucheit and Lastra 2007).

Important safeguards could accompany formal, internationally recognized protection from litigation. Most important would be the application of IMF conditionality and monitoring to provide some degree of assurance that the sovereign borrower was implementing policies consistent with asset preservation.[17] That said, there was little appetite for internationally sanctioned standstills as proposed in the initial SDRM proposal. Private sector opposition focused on the discretion it would assign to the IMF to unilaterally trigger a standstill. A modified proposal (the SDRM II) shifted responsibility for the introduction of a standstill from the Fund to a supermajority of creditors and proposed the use of the "hotchpot rule," by which the claims of creditors initiating proceedings would be counted against the collective restructuring under the SDRM II. Even with these modifications, however, the SDRM II proposal lacked broad international support and was shelved.

Serious concerns were also raised regarding the role of the IMF in determining the size of potential haircuts in early SDRM proposals. Private investors pointed out that as a major creditor with preferred creditor status, the IMF faces potential conflicts in recommending proposed debt writedowns. Their argument reflected the fact that because IMF lending decisions are subject to political influence and outstanding purchases are de facto senior debt, Fund lending entails an inherent subordination of private sector creditors. The corollary is that to avoid such outcomes, strict limits on IMF lending are needed to ensure that IMF claims are truly *de minimus*.

Given the outcry following the release of the initial SDRM proposal, the IMF modified its proposal to redefine its role in the determination of debt discharge. Under the revised proposal, the IMF would have no direct role in determining potential NPV reductions. Rather, the IMF would facilitate the restructuring process by allowing members to utilize its Articles of Agreement to enforce a stay on litigation and help facilitate the debt-exchange process. Nevertheless, owing to sustained, considerable opposition to the SDRM, further work on the proposal was suspended and efforts to promote timely, orderly restructurings focused on the adoption of CACs, which have now become boilerplate

15 The definition of sustainability in cases of sovereign bankruptcy is, to put it mildly, somewhat unsettled. In contrast to the domestic corporate context, in which a firm's assets are valued against the outstanding claims of its creditors, a sovereign's capacity to pay is subject to greater uncertainty. The sovereign analogue to the corporate definition of bankruptcy would be the violation of the inter-temporal solvency condition: the discounted present value of current and future tax revenues (or foreign exchange earnings, in the case of foreign-currency-denominated debt) versus the stock of outstanding liabilities, including, presumably, off-balance-sheet contingent liabilities. But this purely mathematical formula is of little assistance in assessing the sovereign's capacity to lay claim to resources; indeed, it does not take into account that efforts to increase debt-servicing capacity by raising taxes could have unintended consequences in terms of savings and investment decisions and, as a result, the growth of the economy. The fundamental political reality is that when it comes to sovereign bankruptcy, the political feasibility of what *can* be paid to creditors is as important as what bond contracts dictate what *ought* to be paid. These considerations are the basis for the creation of the IMF, which was designed to assist member countries strike a felicitous balance between financing and adjustment. Failure to achieve a judicious balance would, in Keynes' evocative words captured in the IMF Articles of Agreement, lead countries to adopt beggar-thy-neighbour policies "destructive of national and international prosperity" (see IMF 1945).

16 Ongoing litigation with respect to Argentina's bond exchange a decade ago has the potential to fundamentally alter the doctrine of sovereign immunity. The ruling by the New York court (now under appeal with the US Supreme Court), if upheld, would have the effect of estopping financial intermediaries from processing payments to bondholders who accepted restructured bonds unless, and until, holdout investors are made whole. This will likely be a source of uncertainty for some time. See Gelpern (2012).

17 A related issue is the possible systemic effects of a restructuring. The costs of crises can mount significantly because of relationships between sovereign debt, banks and the financial system more broadly. The danger is that banks holding large stocks of sovereign debt would be rendered insolvent under debt-restructuring scenarios. Since the loss of the banking system could result in catastrophic economic disruption to the economy, governments are reluctant to contemplate necessary restructurings; rather than address the problem of excessive debt in a timely manner, governments prevaricate, hoping for a reversal of fortunes in a gamble for redemption.

covenants of sovereign bond contracts, and the voluntary codes of conduct in sovereign debt restructuring negotiations promulgated by the Institute of International Finance (IIF) (Group of Ten 2002; IMF 2002; IIF 2013).

NEW CHALLENGES

In hindsight, one of the concerns that animated efforts to construct a SDRM a decade ago — deadweight losses from protracted collective action problems among private creditors — turned out to be less severe than anticipated, as creditors developed a variety of means to secure voluntary restructurings. Recent bond restructurings have been relatively swift and have featured a high degree of participation and, with the exception of Argentina, were largely devoid of litigation.[18] This largely reflected the use of exchange offers which, by making the voluntary exchange conditional on minimal participation thresholds, reduces potential collective action problems.

The key to a successful restructuring is an exchange offer under which neither the prospective haircut, nor the probability of successfully holding out is too high. In this respect, recent debt exchanges were achieved in the context of a global economy marked by strong growth prospects and investors searching for yield. These factors may have combined in a particularly felicitous fashion to create incentives for borrowers to regain early access to capital markets by not seeking large haircuts. Meanwhile, a number of legal techniques were developed to reduce the incentive from holding out and increase the participation rate in voluntary exchanges. Most significant of these innovations was the use of "exit consents," under which bondholders participating in the bond exchange agree to amend certain non-payment terms of the old bonds as they exit.

These amendments to existing covenants, which do not require unanimity, in contrast to amendments to the payment terms of bonds issued under New York law, reduce the attractiveness of holding unrestructured bonds. Any bondholder opting to not participate in the debt exchange, regardless of motive, is thus faced with the prospect of holding either the new instrument with reduced payment terms or their existing bond, which may be less liquid, attractive and valued.[19] At the same time, some innovations have elevated the seniority of the post-exchange bonds, creating an incentive for bondholders to participate in the exchange. One approach is to make the new instruments more "recontracting-proof" in the event of significant probability of subsequent default by providing a waiver to sovereign immunity that protects payments on the new bonds from attachment by holders of the old bond. This was one technique employed in the 2012 restructuring of Greek debt.[20]

The experience with voluntary approaches over the past decade or more suggests that debt exchanges, once initiated, can result in timely restructurings (see Bi, Chamon and Zettelmeyer 2011). But this is only half of the story: if restructurings are inordinately delayed, as sovereign borrowers seek to avoid the potential disruption and the loss of the imprimatur of credit markets, there can be large economic and social costs. These costs reflect the fact that necessary policy adjustments — fiscal, monetary and structural — are deferred, as the process of debt accumulation continues. The result can be an overhang of debt that distorts incentives for investment, reduces future growth prospects and limits debt-servicing capacity to the detriment of creditors. The accumulation of too much debt can also create political fissures, as citizens of the indebted country balk at the adjustment challenges required to continue servicing the claims of foreign creditors, leading to the possible adoption of policies (default and debt repudiation, followed by the introduction of trade and exchange restrictions) that seek to shift the full burden of adjustment from domestic taxpayers to foreign bondholders.

Moreover, there is a growing awareness that a further restructuring of Greek debt, should it be necessary, would impose punitive losses on remaining private creditors. This possibility reflects the subordination of private sector claims to official creditors, who each claim preferred creditor status. If realized, this outcome could create a constituency for a rules-based framework for the timely, orderly restructuring of sovereign debt that both constrains the ability of rogue creditors to block a restructuring and appropriately sanctions sovereigns that are merely seeking to evade payments discipline.

Such an outcome would close the market to all but the most credit-worthy borrowers. If the remaining Greek bondholders are subjected to further losses, bond markets could very well close to sovereign borrowers; yet, with

18 Two models have governed these restructurings. Under the first approach, informal soundings of creditors' willingness and flexibility with respect to possible restructuring are taken. The goal is to assess expressions of view, rather than formal commitment, with which to develop restructuring offers. The second model used to facilitate voluntary bond exchanges features a formal creditor committee. This approach has several benefits, including the opportunity to "stress test" assumptions on which potential offers are based, particularly whether the requested debt relief is commensurate with the need. In addition, the committee has the capacity to give a proposed restructuring a "good housekeeping seal of approval" and increase the likely acceptance by the creditors whom they represent. In this regard, there is also an implicit understanding that committee members will work to "bring other creditors on board the agreement." In the best circumstances, the result can be an early restoration of credit market access and a return to growth.

19 Terms modified through exit consents include cross default and acceleration clauses, and negative pledge clauses, as well as listing requirements. The latter, in particular, render the bonds less liquid, making them unattractive to a broad class of institutional investors.

20 A far more coercive technique was also employed in retroactively imposing CACs under Greek law.

global banking still fragile, bank lending could be limited as well. In this event, the resulting abrupt, synchronized period of fiscal retrenchment that would be required in many countries could jeopardize growth prospects for them, with negative effects on the global economy. Of course, these developments can be expected to elicit further contractual innovations to protect minority stakeholders.

Recent judicial interpretations of *pari passu*, if upheld on appeal, can also be expected to lead to still more changes (James et al. 2013). The US Court of Appeals for the Second Circuit of New York's interpretation of the *pari passu* clause and its proposed remedy of "rateable payments" is, perhaps, the development with the most far-reaching potential impact on efforts to secure timely, orderly sovereign debt restructuring. The obvious effect of the ruling is that it increases the expected gains from "holding out"; that is, it increases the likelihood that some creditors will refuse to participate in a voluntary restructuring that is acceptable to other creditors in order to extract higher returns (preferential consideration) (see Gelpern 2013b). If this were limited merely to a few recalcitrant creditors, so be it. But the potential pitfall of the Second Circuit decision is that it marries a means of enforcement to the judgment through an injunction against Argentina, paying holders of bonds restructured a decade ago (though the injunction is stayed during the appeals process). At the same time, Gelpern (2013c) notes that the Second Circuit decision could make participation in restructurings less attractive for creditors and create uncertainty for other actors.

The fact that Argentina has successfully petitioned the US Supreme Court to review the Second Circuit's decision offers the prospect of future clarity. A ruling in favour of Argentina would strengthen the existing architecture of voluntary restructuring — albeit at the expense of the holdout creditors. Should Argentina lose on appeal, however, the expected returns from holding out will increase, impairing the ability of distressed sovereigns to affect timely, orderly restructurings through purely voluntary means.

Regardless of the outcome of this specific case, these developments can be expected to spawn efforts to rebalance incentives between participating in a timely, orderly restructuring and holding out. Buchheit, Gulati and Tirado (2013), for example, have proposed that euro-zone countries explicitly immunize payment flows from the grasp of litigating holdouts:

> We believe that the Eurozone has within its power a unique ability to deflate expectations on the part of prospective holdouts that they will realize a higher recovery by staying out of the sovereign restructuring. The goal of such a measure would be to affect the creditor calculus of whether to stay out of a Eurozone sovereign debt restructuring in the first place. Nothing can realistically be done to keep a holdout from obtaining a judgment in a foreign court on a foreign law-governed debt instrument. Attempting to unseat basic tenets of contract law in countries like the United Kingdom (most foreign law-governed Eurozone sovereign bonds choose English law) will meet fierce resistance. But the Eurozone governments could immunize from creditor attachment the assets of a Eurozone country (held within the Eurozone) if the country was engaged in a [European Stability Mechanism]-supported adjustment program.

Immunization of a sovereign borrower's assets would not necessarily protect the sovereign from the kind of litigation that has recently introduced uncertainty into the restructuring process; holdout creditors could still get a judgment against a sovereign. But, by protecting assets and cash flows from attachment, it could rebalance the incentives to undertake such litigation in the first place. The effectiveness of this approach depends, critically, on the willingness of governments to legislate domestically and respect immunization provisions in other jurisdictions. Like the debate on the SDRM a decade ago, it is unclear if there is sufficient political will to pursue this approach.

Moreover, as recent experience has illustrated, bond covenants are subject to innovation and evolution. While the use of exit consents have greatly facilitated voluntary exchanges, it is likely that going forward, future bond issues will feature innovations restricting the use of such techniques, neutralizing this means of securing the high participation rates necessary for successful bond exchanges.[21] The result could be more difficult, protracted restructurings in contrast to the recent experience. This somewhat pessimistic outlook has potential implications for future sovereign debt restructurings and the efficacy of voluntary approaches, because of the impact of the macroeconomic environment on the voluntary restructuring process on the one hand, and reduced potential returns from holding out and pursuing litigation on the other. Going forward, therefore, the medium-term outlook may be far less conducive to voluntary debt exchanges.

21 In this respect, the choice of bonding "technology" — the set of bond covenants and legal rules designed to assuage agency problems in international lending — is endogenous. The switch from bank debt in the 1980s to 1990s occurred because lending in the debt crisis of the 1980s was through the banks and subject to restructuring, while the outstanding bonded debt was deemed *de minimus* and escaped unscathed.

RECOMMENDATIONS

It is important to balance the need to preserve the bonding role of debt to support continued lending with a framework for the timely, orderly restructuring of sovereign debt when required. This objective is not antithetical to markets. Indeed, clear rules of the game are essential for markets to allocate resources effectively. The difficulty is getting the right rules to appropriately balance the twin goals of efficiency and equity. This is what effective domestic bankruptcy regimes do; it is, arguably, what should guide efforts to construct a better international framework for restructuring sovereign debt. More work is required to see to what extent the key principles of domestic bankruptcy regimes can be replicated at the international level. There are three broad areas in which incremental efforts might offer improvements.

LIMITING ASSET SEIZURES AND CREDITOR RUNS, AND PRESERVING ASSET VALUES

First, building on the voluntary contractual approach — particularly the success a decade ago in securing the adoption of CACs — further refinements to bond contracts could be introduced in order to facilitate timely, orderly restructurings.[22] The starting point would be to embed genuine standstill clauses in bond covenants, rather than relying on the status quo, *force majeure* approach or the statutory approach proposed in the SDRM. Such clauses would waive the ability to initiate litigation and could be introduced by writing non-payment of interest and suspension of payments into the contracts, or via trustee relationships based on clear system-wide rules.

The conditions that activate the standstill are a key consideration. Under domestic bankruptcy legislation, the "trigger" is clearly defined by the inability of the debtor to meet its maturing obligations. At the international level, however, this is much less certain. This uncertainty reflects the sovereign's ability to raise taxes or resort to other measures, including inflation, to meet its domestic-currency-denominated obligations. Moreover, a sovereign can invoke *force majeure* to impose a standstill through a suspension of payments. The question is whether the suspension of payments is intended to evade payments discipline or to gain time in which to strengthen policies to facilitate adjustment. In this respect, creating a framework for the international endorsement of standstills to signal when a country is seeking breathing space to identify and implement policy reforms that grow the pie could benefit the sovereign and its creditors.[23] In any event, further work on defining triggers and how to make the standstill effective is clearly needed.

At the same time, efforts could be made to introduce an aggregation clause to address a key problem not resolved by CACs. The purpose of CACs is to overcome the creditor coordination problem inherent in bond issues that require unanimous consent to modify payment terms by allowing for modification by the supermajority (i.e., two-thirds of bondholders). This is an important advance. Yet, bondholders of one bond issue will be loath to accept a reduction in their claims if other creditors are not likewise forced to accept a reduction in their claims; holders of each bond issue have an incentive to "free ride" on the modification of the terms of payments of other issues. When all creditors adopt this stance, no restructuring is possible. The aggregation clauses would subject the totality of a borrower's debts to restructuring should a supermajority of the individual creditor classes agree. They would neutralize the capability of a few investors to impede a restructuring that is acceptable to a broad majority of creditors.[24]

TAX, ACCOUNTING AND FINANCIAL REGULATORY FRAMEWORKS

Second, efforts to better understand the ways in which the myriad of tax, accounting and financial regulatory frameworks in both the debtor and creditor countries interact to affect the debt-restructuring process could yield low-hanging fruit. In the wake of the debt crisis of the 1980s, Dooley and Helpman (1992) proposed that sovereign borrowers provide tax credits to creditors in exchange for reductions in the contractual value of debt. Because the tax credit could be used to pay future taxes on equity earnings in the debtor country, they argued, it would create an incentive for investment and allow creditors to share in the gains from higher future output. The set

22 Efforts could also be made to develop model language for *pari passu* clauses that clarifies the intent of the clause and specifies equal ranking, not equal payment (as subject to recent judicial interpretations).

23 Although efforts to introduce standstills through voluntary contractual approaches could use trustee arrangements — with clear parameters for decision making, consent by representative committees or embedding standstills in private debt contracts — coordination challenges and potential liability concerns pose obstacles to the use of trustee relationships and creditor committees. Trustees are wary of too much discretion, fearing potential litigation. As a result, such arrangements would likely be tightly constrained and apply to only a small subset of possible restructuring scenarios. The probable use of creditor committees is similarly restricted, given the considerable time to organize and secure consent, which would be incompatible with the need for timely action to prevent asset dissipation. The most promising voluntary approach is through insertion in bond covenants, as proposed by Willem Buiter and Anne Siebert (1999) in their Unilateral Debt Rollover Proposal.

24 Aggregation clauses can be effective in cases in which the sovereign borrower has a relatively small number of outstanding bond issues (for example, Uruguay in 2003). They are more difficult to design when the borrower has a large number of different bonds issued in different jurisdictions and denominated in different currencies (for example, Argentina in 2001). See Panizza (2013).

of cases in which the proposal could be implemented is likely restricted to situations in which "willingness" to repay is not in question, and the sovereign borrower is facing a debt overhang that distorts investment incentives; otherwise, lenders would be confronted with the *force majeure* problem and the dilemma of merely having exchanged one unenforceable claim for another. If feasible, however, the proposal could help transform standard debt contracts into state-contingent instruments and further investigation into its potential use could point the way to other options.

At the same time, regulated institutions could have an incentive to participate and encourage timely restructuring. For example, the 1989 Brady bond operation, which unblocked debt reduction for many Latin American sovereign borrowers, was facilitated by favourable regulatory treatment for participating institutions in an environment in which national regulatory authorities exercised considerable discretion. This changed as a result of the 1988 Basel Accords, which moved the international regulatory framework from desired standards to hard-binding floors in restricting the use of capital provisioning to facilitate debt writedowns. Accounting practices have also changed in fundamental ways. The prevailing view prior to the Enron scandal was that assets were best valued by the party with the most information — that is to say, management. Subsequent to the scandal, there is no room for discretion in writing down reserves and accounting for asset values. These factors can be important determinants of debt restructurings. A thorough review of the various factors that may influence the incentives of creditors could identify straightforward, non-controversial measures that would help promote the objective of timely, orderly restructurings.[25]

FACILITATING DISCUSSIONS ON NPV REDUCTIONS

Third, efforts could be made to improve the process for debt reduction. In some respects, the most vexing challenge in sovereign debt restructurings may be securing agreement on the stock of debt that a sovereign borrower can service based on a sustainable program of adjustment; or, expressed differently, the amount of debt discharge that will be required in the case of an unsustainable debt burden. Unfortunately, it is typically also the most difficult aspect of the restructuring process. Views on this issue differ, with the borrower seeking a greater NPV reduction and private creditors hoping to minimize the size of potential haircuts.[26] Given its expertise, access to private information and underlying mandate, the IMF is well placed to inform this process. Yet, it is sometimes viewed with suspicion by private creditors mindful of the IMF's role in assisting its members to strike a judicious balance between financing and adjustment.

While the challenges associated with the debt discharge issue are formidable, efforts can be made to bridge the information gaps that frequently delay the resolution of debt problems and create uncertainty with respect to asset values. In this respect, sovereign debt as an asset class could benefit from the creation of an SDF, which would be independent of the IMF and equipped with permanent staff. The SDF would make proposals based on an analytical review of available information, possibly subject to review by a group of experts. In addition to maintaining confidentiality and facilitating creditor coordination and organization, the SDF would aim to provide balanced information and keep the issue of sustainable economic growth, which benefits the citizens of the indebted country and long-term investors and creditors alike, at the forefront of the discussion.

As a neutral party, the mandate of the SDF would be to provide balanced information and independent professional facilitation, with the aim of aiding a more orderly, transparent and balanced sovereign debt restructuring. The SDF would provide a non-statutory neutral standing body to identify lessons from past sovereign debt distress, bridge information asymmetries and facilitate more predictable, transparent and timely treatment of sovereign debt in periods of extreme distress. The objective underlying the proposal is to encourage earlier, more rapid treatment of debt-servicing problems by addressing many of the challenges identified above, including creditor coordination, debt sustainability assessments and comparability of treatment issues.[27]

While views may differ with respect to its likely effectiveness in enhancing the restructuring process, the SDF is unlikely to impede efforts to secure a more timely, efficient process; in this respect, it passes the Hippocratic test — "do no harm." And, if it could resolve some of the problems that arise under the status quo, it would be worth pursuing.

CONCLUSION

The economic difficulties that continue to confront Greece — including Great Depression-levels of unemployment

25 Regulatory measures could also reduce the accumulation of debt, *ex ante*, reducing the frequency of financial crises. In the wake of the Asian financial crisis, for example, Alan Greenspan proposed the imposition of reserve requirements on foreign bank loans as a means of disciplining lending. Aizenman and Turnovsky (2002) demonstrate that when there is a moral hazard risk, access to a bailout facility will increase the probability of default.

26 As noted in footnote 11, this process can be thought of in terms of a non-cooperative renegotiation game in which the outcome is determined by a number of factors, including the discount rates of the sovereign borrower and the various private creditors, the rate at which potential payoffs shrink over time and the information sets of the various players.

27 Further details on the proposal are found in Gitlin and House (2013).

— and the ongoing litigation over Argentina's debt restructuring a decade ago have reanimated the debate on sovereign debt restructuring. This is not surprising. There is a recurring pattern to discussions of how to improve the framework for the restructuring of sovereign debt. As Reinhart and Rogoff (2009) have documented, the global economy periodically undergoes excessive accumulation of debt that strains debt-servicing capacity and eventually results in default and/or protracted periods of economic dislocation and slower growth. In the past quarter century alone, the issue of sovereign debt has been the subject of international discussions on three occasions: in the wake of the Mexican peso crisis in 1994-1995; following the Asian financial crisis and the Argentine default; and, most recently, as a result of the global financial crisis.

While each successive crisis has spawned innovative responses on the part of borrowers and creditors to deal with the challenges of restructuring, concerns nevertheless remain about the costs associated with the repeated cycle of accumulation, debt-servicing difficulties, followed by default or adjustment. Especially worrisome is the problem of deadweight losses, as sovereigns in distress delay restructuring, hoping to avoid the costs and adopt draconian policies that, rather than restore sustainability, undermine growth with negative consequences on debt-servicing capacity. Meanwhile, creditors, faced with uncertainty about the sovereign's ability as well as willingness to repay, agree to restructurings that may be insufficient, leading to the need for a subsequent restructuring, but only after growth prospects have deteriorated and public support for adjustment has eroded. In too many cases, the result is debt restructurings that are not timely and are insufficiently robust to restore the country to sustainable growth — as the IMF (2013) argues, debt restructurings that are "too little, too late."

Issues discussed a decade ago have taken on increased urgency in the wake of the most virulent global economic crisis since the Great Depression. The global financial crisis has bequeathed large adjustment challenges that hang over the global economy, including large debt burdens in many countries in the euro zone (see Paris and Wyplosz 2014). With monetary policy constrained by the requirements of currency union, fiscal policy and real wages in these countries must bear the full burden of adjustment. Protracted fiscal consolidation and declining real wages fray the social fabric and, ultimately, may not be sustainable. These considerations underscore the importance and urgency of improving the framework for sovereign debt restructuring.

At the same time, concerns about Greek debt sustainability highlight the risk that, should a further restructuring be required, remaining private sector creditors could suffer disproportionately, given official sector claims all purporting to have seniority. In this event, private creditors would likely seek to imbed covenants in future bond issues to immunize them against possible restructurings. While such contractual innovations would protect investors and support continued sovereign lending, they would make it more difficult to restructure debt in the event of a large external shock, for example.

More worryingly, possible legal innovations stemming from the ongoing litigation between Argentina and its holdout creditors have the potential to reverse some of the progress that has been made toward timely, voluntary restructurings through exchange offers. Should Argentina lose its appeal to the US Supreme Court, the concerns that animated efforts to improve the framework for debt restructuring a decade ago — namely, the ability of a small minority of creditors to block a debt restructuring — could once again loom large as sovereign borrowers lose the ability to impose a settlement supported by a supermajority of creditors. The simple fact is that the greater the expected returns from holding out, the greater the challenges in getting agreement.

There is a need for the international community to continue working on a better framework for the timely, orderly restructuring of sovereign debt. The objective of policy should be to minimize the deadweight losses associated with debt restructurings, as do domestic bankruptcy regimes. It is an open question whether that can be done through voluntary means or whether a more formal statutory approach is required.

Getting the broad agreement needed to implement internationally recognized legal reforms will take time. In the interim, given the looming challenges of adjustment in the global economy, it is important that work be undertaken in the following three areas: enriching contractual provisions to allow for automatic standstills and aggregation of restructured debt; reviewing tax provisions and accounting treatments that may inadvertently impede the timely, orderly restructuring of debt; and the creation of an SDF to facilitate the exchange of information and negotiations that are necessary for the efficient recontracting of sovereign debt. The stakes are high; the time for action is now.

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