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# SOVEREIGN DEBT RESTRUCTURING ISSUES PAPER

SKYLAR BROOKS AND DOMENICO LOMBARDI

# SOVEREIGN DEBT RESTRUCTURING: ISSUES PAPER

**Skylar Brooks and Domenico Lombardi**

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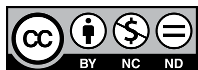

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## ACRONYMS

| | |
|---|---|
| CACs | collective action clauses |
| CETA | Comprehensive Economic and Trade Agreement |
| CSOs | civil society organizations |
| DSA | debt sustainability analyses |
| ESDRM | European Sovereign Debt Restructuring Mechanism |
| ESDRR | European Sovereign Debt Restructuring Regime |
| ESM | European Stability Mechanism |
| Eurodad | European Network on Debt and Development |
| HIPC | Heavily Indebted Poor Country |
| ICMA | International Capital Markets Association |
| IIAS | international investment agreements |
| IMF | International Monetary Fund |
| MDRI | Multilateral Debt Relief Initiative |
| SDAF | Sovereign Debt Adjustment Facility |
| SDF | Sovereign Debt Forum |
| SDRM | Sovereign Debt Restructuring Mechanism |
| SDT | sovereign debt tribunal |

## FOREWORD

This paper is part of the Global Consultations on Sovereign Debt, an initiative launched by the Centre for International Governance Innovation (CIGI) and coordinated by the New Rules for Global Finance Coalition. The consultations seek to identify the full spectrum of proposals and ideas for addressing sovereign debt crises, and organize these ideas in a way that moves the debate forward. To do so, they bring together and galvanize input from a diverse group of stakeholders around the world, including academics, civil society groups, government officials, lawyers and legal experts, international organizations, practitioners, think tanks and others.

Participation in the consultations is organized around webinar discussions, video conferences, workshops, meetings and submissions of written comments. This issues paper — extensively revised following the public feedback received on an earlier draft — aims to provide a framework for the unfolding of the global consultations. As part of its broader global engagement, CIGI has also co-hosted a series of regional workshops on sovereign debt restructuring (first in China, then Africa and next in Latin America) to take stock of regional experiences and perspectives. Once the consultations are concluded later in 2015, CIGI will release a report that synthesizes the contributions from these various stakeholders in a way that can engage with and inform mainstream debates on sovereign debt restructuring.

## EXECUTIVE SUMMARY

This paper provides an overview of the main issues, debates and policy proposals that surround sovereign debt restructuring. The first section outlines the basics of sovereign debt restructuring, including what it is, how it is done and when it has occurred. The second section reviews the recent events and developments that have motivated current discussions over how to better manage sovereign defaults and debt restructurings. These developments and the challenges they pose stem largely from the euro-zone debt crisis and the recent litigation against Argentina. In light of these challenges, the third section outlines the major arguments for and against creating new institutional arrangements to facilitate timely, orderly and fair sovereign debt restructurings. The main arguments against reform are that the current arrangements work relatively well — all things considered — and that reforming the system would encourage debtor moral hazard, which would in turn raise sovereign borrowing costs and leave all parties worse off. The arguments for reform reject this view, and claim that creditor moral hazard, deadweight losses and distributional inequity are current problems that justify reform. Taking the case for reform, section four asks what types of reforms are needed, and reviews three broad approaches to sovereign debt restructuring: contractual, statutory and arbitration. Section five provides an overview of some of the more specific proposals that have recently been put forward for sovereign debt reform. These include: increasing the role of debt reprofiling in certain circumstances; introducing state-contingent debt such as GDP-linked bonds; creating a Sovereign Debt Forum (SDF) to facilitate debtor-creditor cooperation and preserve best practices; strengthening collective action clauses (CACs); immunizing payments systems from third-party interference; establishing a Sovereign Debt Adjustment Facility (SDAF) in the International Monetary Fund (IMF); and building a European Sovereign Debt Restructuring Mechanism (ESDRM). The final sections conclude and suggest a few topics for further discussion.

## SOVEREIGN DEBT RESTRUCTURING: THE BASICS

Sovereign debt restructuring is an exchange of outstanding government debt, such as bonds or loans, for new debt products or cash through a legal process (Das, Papaioannou and Trebesch 2012). To constitute a debt restructuring, one or both of the two following types of exchange must take place: *debt rescheduling*, which involves extending contractual payments into the future and, possibly, lowering interest rates on those payments; and *debt reduction*, which involves reducing the nominal value of outstanding debt. Restructurings often occur after a default, but it is also possible to conduct an early debt restructuring that pre-empts default. In addition to economic variables, the type, timing and terms of a debt exchange are largely determined by negotiations between the sovereign debtor and its creditors.

Sovereign defaults and debt restructurings have been fairly commonplace since the early nineteenth century. New data show that since 1950 alone there have been over 600 individual cases of sovereign debt restructuring worldwide (ibid.). Not surprisingly, the majority of sovereign debt crises are clustered around major boom-bust cycles in international capital flows. Scholars have identified nine distinct lending booms since the early nineteenth century (Sturzenegger and Zettelmeyer 2006; Reinhart and Rogoff 2009). All of these booms inevitably ended in busts, during which some sovereign borrowers were forced to default and/or restructure their debts.

In the past, sovereign debt has typically been restructured through one or more of the following four channels: the Paris Club (an informal group of creditor governments); multilateral financial institutions (namely the IMF and World Bank); the London Club (private creditor committees); and exchange offers (in the case of dispersed

bondholders).[1] Each channel deals with a different form of debt. The Paris Club deals with bilateral loans from creditor governments to debtor governments; the IMF, World Bank and other institutions have provided multilateral debt relief to some of their poorest member states; the London Club deals with loans from banks to debtor governments; and exchange offers target government bonds that are held by a wide range of market actors. Sovereign bonds have been the predominate form of debt affected in almost all of the major waves of default, including in the post-2008 period. Only during the defaults of the 1980s were bank loans more important than bonds (Sturzenegger and Zettelmeyer 2006).

More recently, the outbreak of the euro-zone crisis, combined with the legal saga surrounding Argentina's debt obligations, has sparked a lively debate on how best to prevent and manage large-scale sovereign debt crises, including, of course, defaults and restructurings. The starting point for this debate is the recognition that sovereign defaults and debt restructurings are often messy, painful and unpredictable. A few basic questions follow: Are sovereign debt restructurings *too* costly? Can we reform the international debt architecture in a way that makes sovereign defaults and debt restructurings less likely to occur? Can we reform the architecture to ensure that, when they do occur, sovereign debt restructurings are handled in a more timely, orderly and fair manner? What are the associated costs and benefits of doing so?

## WHAT'S NEW ABOUT SOVEREIGN DEBT RESTRUCTURING?

Although sovereign defaults and debt restructurings are centuries old, the nature of these phenomena continues to change, bringing a number of new aspects of sovereign debt to the forefront of discussion and debate. Indeed, a series of recent economic and legal developments in Europe and the United States have reanimated the sovereign debt debate — last opened up after the 2001 Argentine default — and made sovereign debt restructuring a priority issue on the IMF's agenda and one of the most talked about issues in economic policy-making circles more generally. All of this has, in turn, prompted a rethink of how best to govern sovereign debt restructuring.

### The Euro-zone Crisis and the Economic Dimension of Sovereign Debt Restructuring

The euro-zone crisis kicked-off in 2009 when the newly elected Greek government, led by then Prime Minister George Papandreou, revealed that the reported fiscal deficit of 6.5 percent of GDP was actually double that. Unsurprisingly, Greece's borrowing costs spiked and its bonds were downgraded, compounding the underlying debt problem by causing the economy to contract and the level of debt-to-GDP to rise.[2]

Before long, trouble started to spread to other economies in the euro zone's periphery. Governments in Portugal, Ireland, Spain and Italy saw borrowing costs rise as investors began to sell what now appeared to be risky sovereign bonds to cover the losses incurred on their Greek debt holdings. At the time, the IMF, in concert with the European Commission and the European Central Bank (the so-called "Troika" of official creditors), acted to stave off a deeper and wider financial collapse in Greece and the rest of the euro zone.

It was clear that Greece would need a lot of money and a lot of help, but according to the "exceptional access" lending criteria, the IMF could only lend to Greece if there was a "high probability" of the country's debt being sustainable over the medium term. The problem was that there was not. Still, the IMF wanted to help resolve the crisis and was under mounting pressure from its powerful European members to get involved.

Normally, a country like Greece (whose debt could not be declared sustainable with high probability) would be required to restructure its debt before it could access large-scale IMF resources. But when faced with the prospect of spillover effects from Greece and the heightened potential for debt defaults and restructurings to trigger contagion in a tightly linked economic and monetary union, the Fund decided to offer Greece a more traditional bailout and avoid restructuring.[3]

To enable the Fund to lend to Greece in the absence of a restructuring, the IMF executive board approved in 2010 an amendment to the exceptional access framework, allowing the "debt sustainability" criteria to be waived in cases where there is a "high risk of international systemic spillover effects" (IMF 2010, 20; see also Schadler 2013).

1 An exchange offer occurs when a sovereign bond issuer (who is in or near default and seeking to restructure its debt) offers its bondholders the opportunity to exchange their current bonds for new bonds or financial instruments with different terms.

2 For an overview of the euro-zone crisis, and the role of Greece within it, see Blyth (2013, chapter 2).

3 The euro-zone crisis highlighted the heightened potential for debt defaults and restructurings to trigger large-scale systemic spillovers, in particular in a currency union. This systemic risk is amplified by the fact that sovereign bonds are increasingly integral to the global financial system, which is highly integrated and prone to domino-like collapses (Schwarcz 2011). Since advanced economies' bonds have been considered risk-free assets, financial markets were able to hold massive amounts of these bonds without having to set aside sufficient capital to offset potential losses. During the euro-zone crisis, the exposure of large, undercapitalized and overleveraged banks to sovereign bonds meant that default and/or debt restructuring could trigger a systemic crisis in European and global financial markets (Blyth 2013).

Unfortunately, the combination of external support and internal adjustment provided by the IMF bailout failed to put Greece's public debt on a sustainable footing; in fact, its economy and debt position continued to deteriorate. In 2012, the inevitable could no longer be postponed: Greece underwent the largest sovereign default and debt restructuring in history (surpassing Argentina's historic 2001 default).

Even though it achieved very large debt relief — more than 50 percent of 2012 GDP — the restructuring was not enough to restore growth and debt sustainability. In retrospect, the Fund admitted that the Greek restructuring was "too little, too late" (IMF 2013). If a sufficiently deep debt restructuring had been required at the beginning of the crisis, as the Fund's pre-2010 lending rules specified, Greece's return to economic health could have been much sooner and stronger. The Fund also conceded that its lending framework, even before the 2010 amendment, was not optimally designed to deal with cases where there is considerable uncertainty regarding the sustainability of a country's public debt.

Aside from failing to restore growth and debt sustainability, the Greek debt restructuring was plagued by holdout creditors — i.e., creditors who refuse to participate in an otherwise widely accepted debt restructuring and instead litigate against the sovereign to recover the full face value of the original bonds plus interest.[4] While the Greek restructuring enjoyed a high rate of participation among bondholders (97 percent), those who refused to participate were successful in recovering their investments in full, which only strengthens the incentive for others to hold out from future deals (see Buchheit, Gulati and Tirado 2013a; Xafa 2014).

Partly in response to that, since January 1, 2013, all new euro-zone sovereign bonds have been required to include CACs, which are designed to facilitate creditor coordination in the event of default and prevent holdouts. But evidence on the actual effectiveness of CACs is mixed. Moreover, CACs do nothing to address the "too little, too late" problem — a problem that many now consider more challenging than holdout creditors (see IMF 2013).

Looking forward, as the influential economists Carmen M. Reinhart and Kenneth S. Rogoff (2013) point out, underlying debt dynamics suggest that in the coming years more sovereign debt restructurings will prove necessary in the euro zone's periphery.[5] Other advanced economies do not look much better, for that matter, as central government debt across the developed world reaches a 200-year high point (ibid.). So, while the Greek episode was in many ways unique (Xafa 2014), it highlighted the contemporary relevance of large-scale sovereign debt crises and the challenges of resolving them. A broader message from the euro-zone crisis is thus clear: sovereign debt crises, which now affect relatively rich societies,[6] are not going away any time soon, nor are they getting any easier to handle. This realization has sparked serious discussion and debate, both inside and beyond the Fund's walls, about how best to prevent and manage such crises going forward.

## The Argentina Case and the Legal Dimension of Sovereign Debt Restructuring

Since the outbreak of the euro-zone crisis, sovereign debt restructuring has become a hotly debated topic in international scholarly and policy circles. Interest increased further because of the recent legal battle between Argentina's central government and a small group of holdout creditors, led by New York-based hedge fund Elliot Management, which refused to participate in either of the country's post-2001 restructurings. Since Argentina's bonds were issued under New York law, they are subject to the rulings of New York and higher US courts. In June 2014, the Supreme Court of the United States had the final word in the dispute, denying Argentina's request that the Supreme Court overrule the decision of the lower court in favour of the holdouts.

The New York State judge based his decision on a peculiar interpretation of the *pari passu* (equal treatment) clause contained in Argentina's original bond contract. He ruled that Argentina could not make payments to the 93 percent of creditors who accepted restructured claims in 2005 or 2010 unless it also paid the holdouts the full face value of

4 Sometimes holdout creditors have held the bonds they refuse to restructure from the beginning; other times, they buy the bonds on secondary markets for pennies on the dollar after default had already taken place and then sue for full repayment of the original value of the bond plus accrued interest.

5 For some countries in the euro zone's periphery, and to a lesser extent for developed countries more generally, current economic outlooks suggest that the normal ways in which governments reduce their debt may not provide sufficient relief to restore debt sustainability. First, growth prospects in Europe and Japan appear too weak for these economies to grow their way out of debt. Second, fiscal adjustment (i.e., austerity) is growth depressing at worst and insufficient to meaningfully reduce debt-to-GDP ratios in a low-growth environment at best. It is also difficult to implement because it is so deeply unpopular (Mody 2013). Third, in the euro zone, exchange rate and monetary policies are not available tools to assist with national debt reduction. As a result of these challenges, many governments may be forced to resort to sovereign debt restructuring (Reinhart and Rogoff 2013).

6 The euro-zone crisis showed that, contrary to conventional wisdom, advanced economies are not immune to severe sovereign debt crises. Further, crises in advanced economies can pose larger systemic risks than those in emerging and developing economies.

the bonds plus interest.[7] If Argentina were to comply with the judge's ruling — so far, it has not — it would have to pay roughly US$15 billion to holders of defaulted bonds, a potentially devastating blow to its already depleted foreign currency reserves (Devereux and Van Voris 2014).

The problem with the court's decision, beyond the severe financial strain it puts on Argentina, is that it sets a legal precedent under New York law — the law governing a large portion of sovereign bonds — that threatens to make it more difficult for all countries in the future seeking to restructure their debt held in the form of bonds (Frankel 2014). By ruling that Argentina's holdout creditors, most of whom bought their bonds on secondary markets after default and at a deep discount, must be repaid in full if anyone is to be repaid at all, the court's decision has rewarded recalcitrant creditors — referred to pejoratively as "vulture funds" — and punished cooperative ones, thus creating a perverse incentive for all creditors to hold out from future restructurings. The holdouts claim they tried to strike a fair deal with Argentina on several occasions but were ignored and offered only harsh "take-it-or-leave-it" bond exchanges. However, given the lack of transparency in creditor-borrower negotiations, claims made by both Argentina and holdout creditors are difficult to substantiate. Still, as both José Antonio Ocampo (2014a) and Joseph Stiglitz and Martin Guzman (2014) point out, granting the holdouts full repayment via legal mandate is questionable. Since the risk of default is already priced into the bond vis-à-vis the interest rate or premium, lenders should not be able to charge high risk premiums *and* use legal mechanisms to enforce full repayment. Here, the legal mechanism overrides the need for the market mechanism for restructuring debt, and vice versa. The two cannot co-exist. If there were a legal mechanism to enforce full repayment, the risk of default and the premiums charged to previously risky sovereign borrowers would be low. In the absence of such a legal mechanism, markets will continue to deal with the risk of default through the market mechanism of risk premiums.

To say that Argentina is a "uniquely recalcitrant debtor" is certainly not a fringe view. But in setting legal precedent under New York law — the law governing a large portion of sovereign bonds — the court's decision creates a perverse incentive for all creditors to hold out from future restructurings, essentially making them almost impossible to achieve.

As a recent IMF staff paper (2014b, 31-32) put it, "by allowing holdouts to interrupt the flow of payments to creditors who have participated in the restructuring, the decisions would likely discourage creditors from participating in a voluntary restructuring," and "by offering holdouts a mechanism to extract recovery outside a voluntary debt exchange, the decisions would increase the risk that holdouts will multiply and creditors who are otherwise inclined to agree to a restructuring may be less likely to do so due to inter-creditor equity concerns." As *The Economist* (2013) commented, strict adherence to the *pari passu* clause "would make restructuring sovereign debt sold in New York impossible, since no one could be paid without 100% participation in a swap." Clearly, then, the decision has potentially made restructurings much harder to agree to, let alone enforce.

### Issues for Discussion

- What new lessons on sovereign debt restructuring has the euro-zone crisis offered? How can these lessons help prevent or manage future crises?
- What are the main challenges that arise from the Argentina litigation? How might states and markets respond to these challenges?
- What types of legal contracts should govern sovereign debt obligations? What types of provisions might they include?

## REFORMING THE INTERNATIONAL DEBT ARCHITECTURE: FOR AND AGAINST

### Against

The case for a new and/or improved approach to sovereign debt restructuring rests on the assumption that the current decentralized, market-based approach is deficient. But not all observers share this assumption. Indeed, some contend that the prevailing ad hoc approach has a remarkably strong track record of success. Hung Tran, executive managing director of the Institute of International Finance, argues that all of the ad hoc bond restructurings (of which there have been 34) since the first bond exchange of modern times have worked reasonably well, with the exception of Argentina in the 2000s (Tran 2014).[8] On average, he notes, restructurings were consummated within 10 months of the announcement of a restructuring, within seven months of starting negotiations and with high levels of participation (95 percent). From this perspective, the current approach

7 It is important to note that historically there has been no standard or boiler plate *pari passu* clause, and that the language used in Argentina's 1994 Fiscal Agency Agreement was unique — i.e., different from almost all other *pari passu* clauses in sovereign bond contracts. The point is that the judge's interpretation of Argentina's *pari passu* clause cannot necessarily be considered novel or unconventional, since there is no standard version, and thus no standard legal interpretation, of such clauses. (For making this point clear, the authors thank David Spencer of the Tax Justice Network.)

8 For Tran, the first modern restructuring is Mongolia in 1997. Jo Marie Griesgraber notes that Tran does not consider the cases of Zambia and Greece.

is successful and obviates the need for any substantive reform of the international debt architecture.[9]

Advocates of the ad hoc approach also maintain that in order to preserve well-functioning international debt markets, sovereign bond contracts should be honoured. When, for unavoidable reasons, contracts have to be changed, there should be a process whereby the change in contract is accepted by both sides of the contractual agreement (Tran 2014). Although Tran (2014) admits that the prevailing market-based approach is not perfect, he contends that it should not be perfect, for breaking contracts should not be made easy to do. The rationale behind this view is not simply that breaking contracts is wrong, but rather that failing to honour debt contracts distorts incentives and would lead to more, not fewer, sovereign debt crises.

Another argument against reform is that making sovereign debt easier and less costly to restructure will encourage imprudent borrowing by sovereign debtors, who will no longer have the threat of a costly and painful restructuring to deter them from borrowing more than they are able or willing to repay. According to this view, sovereign defaults and debt restructurings are supposed to be costly; if they are made less costly, they will occur more frequently. And if they occur more frequently, investors will be increasingly reluctant to lend to sovereign debtors, raising their external borrowing costs and making it harder for developing and emerging market economies to finance their development needs (Rieffel 2003; Tran 2014). In other words, this argument posits that making sovereign debt restructuring less costly will make international sovereign borrowing more expensive.

### For

The counter-argument to that view is that even if it becomes easier or less costly to default or restructure, countries will continue to face strong incentives not to, including the incentive to avoid higher future borrowing costs (Sturzenegger and Zettelmeyer 2007; Borensztein and Panizza 2008). Another incentive for sovereigns to repay their debt stems from the fear of losing access to international capital markets. As Ugo Panizza, Federico Sturzenegger and Jeromin Zettelmeyer (2009, 662) document, a number of studies illustrate that "the threat of exclusion from future borrowing is sufficient to sustain sovereign lending" (see also Amador 2003; Eaton and Gersovitz 1981). They note, however, that, according to the evidence, fear of being barred from capital markets cannot be the only or even the main motivation for sovereigns to repay their debts (ibid.). In addition to higher borrowing costs and a loss of reputation in international credit markets, the costs of default for a sovereign might include sanctions and trade retaliations from bilateral official creditors, costly litigation and legal rulings (as the recent US Court ruling in favour of Argentina's holdout creditors illustrates), and, if a high proportion of a sovereign's bonds are held by its own residents, domestic financial crises and recessions (ibid.). One study also examines the political consequences of debt crises, concluding that they are particularly bad for incumbent politicians and finance ministers (Borensztein and Panizza 2008).

As many scholars and practitioners note, even the most comprehensive reforms could not make defaults and restructurings entirely painless for the sovereign. It follows that even modest reforms, defaults and restructurings will continue to inflict significant economic, political and social damage on the countries that undertake them, and they will thus continue to be seen as highly undesirable. From this point of view, countries do not default and/or restructure because they can or want to, but rather because they are unable to repay their creditors. Accordingly, creditors may even welcome the introduction of mechanisms that facilitate timely and orderly restructuring "when sovereign debts are rendered unsustainable by circumstances not of the debtor's making" (Eichengreen 2006, 446).

For these reasons and others, a number of observers remain firm in their belief that the handling of sovereign debt restructurings can be improved to the benefit of creditors and debtors alike. The standard rationale for establishing a more formal sovereign debt restructuring framework rests on two economic considerations and one political concern (Schadler 2012). From an economic perspective, it is argued that better restructuring arrangements will help to reduce creditor moral hazard and deadweight losses. From a political standpoint, creating a system with formal rules and procedures for restructuring unsustainable sovereign debt — rather than simply bailing out investors — would enhance the perceived fairness and thus the legitimacy of crisis resolution strategies.

### Creditor Moral Hazard

The problem of creditor moral hazard arises from the track record of IMF lending, which creates an expectation among creditors that the Fund will invariably bail out troubled sovereign debtors — and by extension their creditors — in order to avoid a costly default.[10] With this safety net in place,

9 It should be noted that many apparently successful debt restructurings are insufficient to restore debt sustainability and are therefore followed by repeat defaults. In a review of distressed debt exchanges, Moody's (2012, 1) reports that "Thirty-seven percent of the 30 sovereign distressed exchanges were followed by further default events." (For this point the authors thank Bernhard G. Gunter of the Bangladesh Development Research Center.)

10 Some would note that the track record of IMF lending is not the only source of creditor moral hazard. For example, a legal precedent or court ruling that made debt repayment more likely, all else equal, could also lead to what would otherwise be considered overlending or overly risky lending. (This view was brought to the authors' attention by Jurgen Kaiser of Jubilee Germany.)

private creditors engage in excessive and risky lending to sovereigns, allowing for the unsustainable buildup of sovereign debt and contributing to the bankruptcy crises that follow. Mitigating moral hazard "requires a clear and credible threat of losses through restructuring when lending has been excessive" (Schadler 2012, 13). But the IMF has a hard time making credible commitments of this sort because of the so-called "dynamic inconsistency problem" — that is, the potential for actions that may be optimal before the fact to be suboptimal after the fact if some condition is not satisfied. As James A. Haley (2013) explains:

> In the case of sovereign bankruptcy, the commitment not to provide IMF (or other official sector) resources is entirely sensible in that it creates incentives for sovereign borrowers and their private creditors to come to a timely restructuring. But if such a restructuring is not forthcoming, and the result is a financial crisis that has external effects on global markets, the commitment not to provide financing may look decidedly sub-optimal, particularly for an institution whose mandate is global financial stability.

The solution to this problem is to put in place formal restructuring procedures that stipulate the conditions under which restructurings will take place, and that reduce the costs of pre-emptive restructurings enough to be credible (Schadler 2012).

While many see it as a central concern, empirical evidence on the existence of creditor moral hazard is inconclusive. Some scholars find robust evidence in support of the moral hazard thesis, while others find no empirical foundation for this argument.[11] The evidentiary ambiguity surrounding this question is at least in part a result of the difficulty of accurately identifying or measuring cases of moral hazard.[12]

## Deadweight Losses

Deadweight losses are essentially efficiency losses that arise from information and coordination problems, and that reduce general economic welfare. They are "lose-lose" in the sense that "value is destroyed without an offsetting benefit" — the debtors' loss does not represent a corresponding gain for the creditor (Sturzenegger and Zettlemeyer 2006, 270). Insufficient information about a debtor's willingness and ability to pay, for example, can result in efficiency losses by encouraging creditors and debtors to engage in protracted disputes, often involving costly litigation, which ultimately wastes resources and delays a restructuring agreement (Haley 2014). Coordination problems can also result in inefficient outcomes when creditors fail to effectively cooperate with one another, even when doing so would lead to better outcomes for all parties (Schadler 2012; Blyth 2013).[13] The lack of a coordinating institution also allows for holdout creditors. One of the core ways in which coordination and information problems cause efficiency losses is by delaying the restructuring process and, in doing so, postponing the country's return to economic health.

A delayed and disorderly restructuring can lead to a prolonged period of economic stagnation. As Barry Eichengreen (2006, 435) explains:

> During this period, lenders receive no interest, and the borrowing country has no access to international capital markets. An extended loss of access may cause the exchange rate to collapse and banks with foreign currency-denominated liabilities to fall into crisis. This extended loss of market access and the recession it provokes have high costs for the country.... Officials in the borrowing country may thus feel compelled to pursue costly policies to avoid this plight, running down reserves, raising interest rates, and putting the economy through the deflationary wringer.

Uncertainty on the part of sovereign debtors over the best way to deal with a sovereign debt crisis can also be a source of delay and thus inefficiency. Because it is notoriously difficult to ascertain whether a distressed debtor is insolvent or merely illiquid, it is sometimes difficult to determine the appropriate, and necessary, policy response to a debt crisis. In a climate of uncertainty, national authorities may avoid or postpone taking politically unpalatable, yet necessary, measures (such as sovereign debt restructuring) because they cannot guarantee that these measures are absolutely necessary. Governments thus "gamble for redemption," which can delay a necessary restructuring and, in doing so, contribute to what the IMF has identified as a particularly problematic aspect of the status quo: the

11 Haldane and Scheibe (2004), Dell'Ariccia, Schnabel and Zettlemayer (2002) and McBrady and Seasholes (2000) find evidence of moral hazard. Lane and Phillips (2000), Jeanne and Zettelmeyer (2001) and Kamin (2002) find no evidence of moral hazard.

12 While the existence of creditor moral hazard may be in doubt, there is evidence that creditors have been overcompensated for the risk of default (Spiegel 2010). (The authors thank Barry Herman of The New School for bringing this evidence to their attention.)

13 Blyth (2013, 63) describes one of the key dilemmas that results from collective action problems: "In such situations bond market investors face a dilemma. If they believe that bonds are going to fall further in value, they should get rid of them as soon as possible. But if they do dump the asset in question, they run the risk that everyone else holding these assets will do the same, with prices collapsing as a result."

tendency of distressed debtors to restructure "too little, too late" (IMF 2013). The 2012 Greek debt restructuring came a full two years after Greece lost market access and was put on an IMF-supported adjustment program, even though it was widely believed that Greece would eventually have to restructure its sovereign debt (Xafa 2014). As the Greek episode attests, pressure or assistance from the international community can also influence a sovereign's decision and ability to delay restructuring. This reality raises a further problem with the current approach: leaving IMF lending decisions to discretion — rather than clearly defined rules and procedures — increases the likelihood that political pressures within IMF membership will influence policy decisions in a suboptimal direction.

Many argue that these costs could be minimized if governments with unsustainable debts took early action to restructure and were also able to secure the cooperation of their creditors in doing so (IMF 2013). But early or timely restructurings would solve only half of the "too little, too late" problem. The other half, the fact that debt restructurings are often too small to provide the sovereign with sufficient debt relief, would remain a pressing problem. In the domestic context, insufficient restructurings are largely avoided vis-à-vis formal bankruptcy procedures, which aim to provide viable firms with a fresh start. Advocates of an international bankruptcy mechanism therefore point out that, in the absence of formal procedures, there is nothing to ensure that troubled sovereigns, even after a default and restructuring, are given a fresh start from which to launch their economic recovery.[14] For these observers, a more efficient and effective mechanism for resolving the information and coordination problems associated with sovereign debt restructuring is badly needed.

## Distributional Issues

Although it is often cloaked in technical language, sovereign debt restructuring is in fact a politically charged issue, inescapably wrapped up in deep-seated normative judgements about equity and the appropriate balance of public-private burden sharing during financial crises.

The accumulation of unsustainable debt by a government can raise questions of intergenerational equity (Buccheit and Gulati 2010). If a government borrows money to invest in the productive capacity of its economy, then that borrowing and investment will likely benefit future generations. The fact that such generations will have to manage and/or repay the debt that funded those productive investments is inconsequential, because the economy from which they draw their earnings (and tax revenue) will likely be larger and more vibrant as a result of the debt-financed investments made by previous governments. In contrast, governments can accumulate large amounts of debt for fundamentally unproductive purposes, such as to fund projects that serve narrow (special) interests or to "buy votes" that help secure re-election for incumbent politicians. If future generations are left to service that debt, it is equivalent to a transfer of wealth from the future to the present, since only the current generation benefits from spending the money that future generations will have to repay. Intergenerational equity is thus one of the distributional issues tied up in the broader issue of sovereign debt.

Intergenerational equity is not the only, nor the most contentious, distributional issue at the core of sovereign debt and sovereign debt restructuring. Inter-creditor equity is also a key concern for those seeking to resolve crises in a fair and efficient manner. Here, the main sources of tension lie in balancing the interests of short-term and long-term holders of sovereign debt, on one hand, and foreign and domestic creditors, on the other. Current restructurings tend to affect only holders of a particular bond issuance or series, rather than all bondholders. Not being able to bind all bondholders across different bond issuances to a common restructuring agreement is referred to as an aggregation problem. The practical implication of this problem is that not all creditors are treated equally (Brooks et al. 2015). For example, there is a key distinction between creditors whose claims will reach maturity during a debt crisis or IMF program (short-term claims) and those with longer-term claims that will not mature for several years. The distribution of losses between these two generic types of creditor depends on the way in which a particular debt crisis is resolved.

Debt crises have traditionally been dealt with through IMF bailouts. When they are, short-term creditors escape relatively unscathed. The IMF comes to occupy spots left by the creditors it bailed out. Since the IMF is a de facto senior or preferred creditor and is, therefore, almost always paid back on time and in full, the longer-term creditors who "stayed in" (often because they had little choice) are pushed further down the creditor food chain (which determines who gets paid, on what terms and when).

In crises that are dealt with through sovereign debt restructuring or "bail-ins," however, it is mostly the shorter-term claimants who bear the brunt of the restructuring, because their claims mature (i.e., are supposed to be repaid) at the same time the sovereign is experiencing difficulty servicing its debt. They must therefore reschedule and/or accept a nominal loss on their claim.

14 An important goal of the IMF's and World Bank's Heavily Indebted Poor Country (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) was to provide the eligible countries with a fresh start by relieving all (or almost all) of their debt. For an overview and analysis of debt restructuring in Africa, including the role of the HIPC and MDRI initiatives, see Brooks, Lombardi and Suruma (2014). Recently, the idea of having a Heavily Indebted Middle Income Country Initiative, specifically for the Caribbean countries, has been put forward (see Ramcharan 2015).

The nationality of bondholders — in particular, whether they are foreigners or domestic residents — can also be an important determinant in the differential treatment of creditors. For example, domestic and foreign creditors were treated differently in the last restructurings of Argentina, Jamaica, Dominica, Russia and Uruguay, to name but a few cases. There are a number of reasons why sovereigns might want to discriminate for or against domestic creditors in their debt restructuring strategies (Erce 2013). First, residents are subject to the domestic legal and regulatory system, making them easier to persuade or coerce into participating in a debt exchange. Second, a sovereign may choose to honour its external debt obligations while restructuring its domestic ones in order to retain access to international capital markets — a particularly attractive strategy for states with underdeveloped domestic financial markets. Third, a sovereign may choose to restructure its external debt obligations while remaining current on its domestic ones in order to mitigate the domestic financial fallout that could result from defaulting on and/or restructuring claims held by local banks and businesses. Finally, domestic residents may have more influence than foreigners over their governments' decision making and, thus, a greater ability to shape outcomes that favour domestic creditors (ibid.). For these reasons, inter-creditor equity can be a contentious aspect of sovereign debt restructuring, with a direct impact on the perceived fairness and efficacy of various crisis resolution strategies.

There are also a number of distributional concerns that, in a simplified form, break down along public-private lines. For ideological and material reasons, many private sector representatives and free-market advocates oppose the creation of any regime or mechanism that would make it easier for governments to restructure their debts because sovereign debt restructuring represents a redistribution of capital from creditors, often private bondholders, to sovereign debtors. When a sovereign restructures its debt, it is "bailing in" its creditors by not repaying them in full and/or on time. This represents a financial loss for creditors and a relative gain for debtors.

On the other hand, sovereign debt crises often follow private sector financial crises because governments choose to bail out insolvent financial firms at a time when recession-induced government expenditures, such as for unemployment insurance, are rising and tax revenues are falling. Thus, private losses that generate financial crises are often socialized and borne by the public sector, representing a large redistribution of pain from private financial actors to the population writ large. Furthermore, when the IMF and bilateral official creditors bail out countries with sovereign debt problems, they are essentially bailing out the sovereign's private creditors. If the sovereign is not insolvent but rather illiquid,[15] there is nothing necessarily wrong with the bailout strategy from a crisis management perspective. This strategy does, however, place responsibility for the crisis squarely on the borrower instead of the lender. This is problematic insofar as creditors that expect to be bailed out in the event of a sovereign debt crisis have an incentive to lend in an excessive and imprudent manner to sovereigns. There is thus a compelling argument in favour of more burden sharing between debtors and creditors during sovereign debt crises. When liquidity support (i.e., a bailout) is coupled with a domestic adjustment program, usually involving painful austerity measures, this problem is made more acute. In this case, domestic populations — in particular those at the lower end of the income distribution, who rely most heavily on social services — are forced to bear the brunt of the crisis, while international lenders escape unscathed. For many, this is a deeply unfair distribution of the costs and benefits of sovereign debt and sovereign debt crises. These concerns highlight the fact that sovereign debt and the resolution of sovereign debt crises are matters of social justice, not simply economic efficiency.

### Issues for Discussion

- What are the potential costs and benefits of reforming the international debt architecture? In a globalized financial system, are sovereign debt crises inevitable and bound to be costly, or are there certain types of reforms that could reduce the frequency and costliness of such crises?
- How can we best balance the different distributional concerns that arise from sovereign debt and sovereign debt restructuring?
- Are lenders and borrowers equally (or differentially) responsible for the buildup of unsustainable debt? What does that imply for burden sharing in the resolution of sovereign debt crises?

## WHAT TYPES OF REFORM ARE NEEDED?

Among those who agree on the need to improve the handling of sovereign debt restructurings, there is much debate over what types of reforms are required, with opinions traditionally split between those who advocate a market-based, contractual approach, on one hand, and those who would prefer to see a more formal, statutory

15 If a sovereign is illiquid, it does not have the resources at its disposal to meet its current debt obligations. But its medium- to long-term debt burden could still be sustainable. If it is insolvent, its medium- to long-term debt burden or debt-to-GDP ratio is fundamentally unsustainable. Put differently, illiquid sovereigns might only need a short-term cash injection to continue servicing their debts, while an insolvent sovereign has much deeper problems that require more fundamental changes to restore its debt sustainability.

mechanism, on the other. Recently, a number of alternative proposals have been put forward, some of which do not fit cleanly into the contractual-statutory dichotomy (Brooke et al. 2013; Buchheit et al. 2013; Gitlin and House 2014; IMF 2014b).

## The Contractual Approach

One perspective on why sovereign debt restructuring is costly and unpredictable is that relations between creditors are subject to incomplete contracts (Bolton and Jeanne 2002). From this perspective, a good way to ensure more timely and orderly restructuring is to clearly outline the procedures for restructuring when the bond is first issued. Writing the terms of a restructuring into the bond contract can help mitigate the collective action problems that lead to deadweight losses by binding creditors to a common and well-specified restructuring procedure.

CACs, a widespread feature of sovereign bond contracts, embody the contractual approach to sovereign debt restructuring. These clauses consist of legal provisions that are written into the contracts that govern sovereign debt obligations. They typically include provisions that: establish a bondholders' meeting in the event of restructuring and specify procedures for selecting the bondholders' representative (collective representation clauses); prevent individual bondholders from taking the sovereign to court (majority enforcement clauses); and specify the size of the (super) majority of bondholders needed to amend payment terms (majority restructuring clauses) (Das, Papaioannou and Trebesch 2012; Gulati and Weidemaier 2014).

CACs have been a common feature of the London bond market since the late nineteenth century (Das, Papaioannou and Trebesch 2012). In the United States, however, CACs did not become widely used until 2003, when Mexico became the first major emerging market debtor to include CACs in its sovereign bonds — a move that precipitated a rapid and widespread shift toward the use of CACs for emerging markets. At the end of 2002, only about 30 percent of emerging market sovereign bonds included CACs (and most were issued in London). By 2004, close to 90 percent of new international bonds issued included CACs, and by the first half of 2005 the figure had approached close to 100 percent (Helleiner 2009). In response to the euro-zone crisis, Europe has introduced a new requirement that all euro-zone sovereign bonds issued after January 1, 2013, include CACs (Bradley and Gulati 2013; Gulati and Weidemaier 2014).

Although the more widespread use of CACs in sovereign bond issuances seems to represent a step in the right direction, many argue that the presence of CACs alone is not enough to ensure a timely and orderly restructuring process.[16] Empirical evidence on the actual effectiveness of CACs in past debt restructurings shows they are not sufficient to address the problems (Das, Papaioannou and Trebesch 2012). As mentioned, the Greek restructuring enjoyed a high rate of participation among bondholders (97 percent), but those who refused to participate were successful in recovering their investments in full, strengthening the incentive for others to hold out from future deals. Indeed, the IMF (2013) notes that the Greek restructuring highlighted the limitations of CACs in addressing non-participating creditors. The recent US court ruling in favour of Argentina's holdout creditors may also make the problem more acute going forward (IMF 2013; 2014). Lee C. Buchheit, Mitu Gulati and Ignacio Tirado (2013, 1) are convinced that "any future Eurozone debt restructuring will be surely plagued by the problem of non-participating creditors." More importantly, the Greek restructuring was seen as a case of "too little, too late" — a problem that CACs are not equipped to handle (IMF 2013; Gitlin 2014). In fact, some scholars go as far as to argue that the inclusion of CACs in bond issuances can actually increase incentives for some creditors to free ride on others and, in doing so, further delay the resolution of a debt restructuring deal (Pitchford and Wright 2010). For some, the persistence and potential worsening of the holdout creditor problem only reinforces the need to improve the way sovereign debt restructuring is governed beyond the contractual approach of CACs.

One of the most common criticisms of CACs is that they are unable to aggregate all of the sovereign's creditors and bind them, along with the sovereign, to a common restructuring agreement. Since sovereign bonds are typically restructured on a series-by-series basis, only a portion of a sovereign's creditors are involved in any given restructuring. And since CACs only apply to a single series, it is relatively easy for holdout creditors to buy a "blocking position" within a single bond series (typically over 15 percent of the bonds in that series) and undermine an otherwise widely accepted restructuring deal. In response to this shortcoming, the International Capital Markets Association (ICMA) has been promoting a new version of CACs with a stronger "aggregation" feature. As a recent IMF staff report (2014a, 1) states, "Broad support has emerged for CACs to include a 'single limb' voting procedure that will enable bonds to be restructured on the basis of a single vote across all affected instruments, subject to safeguards designed to ensure inter-creditor equity and minimize the risk of sovereign manipulation." The new ICMA CACs include this single-limb provision but also allow for the adoption of a "two-limb" voting procedure, enabling differential treatment among creditors.

16 See Bi, Chamon and Zettelmeyer (2011); Bradley, Cox and Gulati (2010); and Das, Papaioannou and Trebesch (2012).

## THE RISE AND FALL OF THE SDRM

In the wake of a series of large-scale emerging market crises, and with the 2001 Argentine crisis brewing, a few top US officials began to consider proposals for an international sovereign bankruptcy regime. In September 2001 (just prior to the Argentine default), US Treasury Secretary Paul O'Neill approached both senior IMF management and the US Congress to suggest they give serious consideration to the idea of an international bankruptcy law for sovereign debtors (Helleiner 2009, 8). In November 2001, then IMF First Deputy Managing Director Anne Krueger formally proposed a "sovereign debt restructuring mechanism." Housed in the IMF, the SDRM would provide a formal bankruptcy procedure for sovereigns. In short, it would be a legal mechanism designed to approve payments standstills for sovereign states experiencing severe debt servicing difficulties, and facilitate the restructuring and, if necessary, writing down of sovereign debts (Fischer 2003). An SDRM, it was argued, would address the moral hazard problem by minimizing private sector bailouts and, by establishing a more timely and orderly way of resolving sovereign debt crises, it would provide benefits to both debtors and creditors (Helleiner 2009).

In the end, support for the SDRM was not strong enough to overcome the opposition of private creditors, emerging market sovereign debtors (namely Mexico and Brazil) and key officials within the US government. Private creditor associations lobbied key individuals within the US Treasury Department and the IMF and, when CACs emerged as a potential alternative to the SDRM, they threw their weight behind this approach and even lobbied sovereign debtors to do the same. The logic ran that the widespread adoption of CACs would render the SDRM unnecessary, but sovereign debtors still worried that their support for any restructuring mechanism — even CACs — would compromise their perceived creditworthiness. In the end, it took direct lobbying on the part of creditors to convince the Mexican government that issuing CACs in its sovereign bonds would not compromise its access to affordable external credit, whereas the SDRM would. Ultimately, Mexico's decision in 2003 to include CACs in its bonds was a success, marking the SDRM's downfall (Gelpern and Gulati 2004).

These revamped clauses, which have been adopted by Chile, Ethiopia, Kazakhstan, Mexico and Vietnam, are intended to deal with this issue by aggregating and binding all bondholders to a single restructuring process. It should be noted, however, that even if these new CACs are widely adopted and ultimately prove effective in dealing with the "aggregation problem," it could take up to a decade for them to work their way into the existing debt stock. In light of this challenge, Gregory Makoff and Robert Kahn (2015) discuss how to speed up the conversion of existing debt contracts to the new ICMA format, including bond amendments and exchange offers. As a way forward, they suggest that creditors and debtors could be brought together "to discuss active strategies to accelerate the transition of outstanding stocks of debt to the new format," and that the G20 could play a leadership role in this type of initiative (ibid., 8).

### The Statutory Approach

Many observers believe that CACs are insufficiently robust to solve many of the problems associated with sovereign debt restructuring. A number of them have called for the creation of a more formal, statutory mechanism or framework for restructuring sovereign debt — something akin to an international bankruptcy procedure for sovereigns. The most concrete and high-profile proposal of this sort was IMF First Deputy Managing Director Anne Krueger's call in 2001 for the creation of a Sovereign Debt Restructuring Mechanism (SDRM) (Krueger 2001). Grounded in an international legal framework that would bind all countries and supersede the provisions of private loan agreements, this treaty-based approach would require amending the IMF's Articles of Agreement, which is intentionally difficult to do.

In general, a statutory restructuring mechanism would presumably include four key features (Eichengreen 2006). First, in the event of a restructuring, the mechanism would impose hard restraints on litigation so as to prevent a costly and time-consuming "rush to the courthouse" on the part of creditors (Kolb 2011; Haley 2014). Depending on the design of the mechanism, restraints on litigation could be subject to approval by a supermajority of creditors. Second, there would be a procedure for assigning creditor seniority and ensuring that new private lending is protected from restructuring. Third, a statutory mechanism would allow a supermajority of creditors to vote to accept the terms of a restructuring arrangement, and ensure that minority creditors were bound by this decision. Finally, the mechanism would include a venue and process for fact checking information, resolving disputes and overseeing the bondholder voting process. As Eichengreen (2006, 443) explains, "a statutory approach like the sovereign debt restructuring mechanism elaborates the US-style court-led approach to debt restructuring by relying on statutes to create a quasi-judicial process for debt reorganization, while collective action clauses attempt to extend the traditional UK-style approach that relies on contracting and on self-organizing creditors, with little if any court

involvement." Proponents of the statutory approach argue that it would solve the aggregation problem of not being able to bind all bondholders to a restructuring deal that a supermajority of creditors agrees to. But critics claim that a statutory arrangement would be arbitrary and would unduly interfere with market mechanisms (Rieffel 2003). They also contend that such an approach is politically infeasible. It is indeed true that in the early 2000s the SDRM proposal failed to receive sufficient support from state and market actors.

Yet, the idea of a statutory approach to sovereign debt restructuring has not been abandoned. On September 9, 2014, the United Nations General Assembly passed a resolution that calls for the creation of a "multilateral legal framework for sovereign debt restructuring." One hundred and twenty-four countries voted to pass the resolution. Tellingly, almost all countries with major financial centres voted against it, including the United States, the United Kingdom, Germany and Japan. While the final outcome of this resolution will not become clear for some time, it is a significant development and, for many, an important step in the right direction. Among other things, the resolution indicates that the governments of most countries support a more comprehensive, treaty-based approach to sovereign debt restructuring. It also shows that many governments do not see the IMF as the only or even the best channel through which to pursue reforms to the international debt architecture. Nor is the IMF viewed as the natural home for any future debt restructuring mechanism once created. To the contrary, several developing countries distrust the IMF and question its legitimacy.[17] Some also question whether the IMF can be an objective arbiter of sovereign debt disputes, since it is itself a creditor with a material interest in the resolution of debt crises. For such a creditor to act as an "impartial" judge would violate bankruptcy standards of neutrality.

## A Sovereign Debt Tribunal and Arbitration Process

A number of scholars and civil society organizations (CSOs) have advanced or endorsed proposals for a "fair and transparent" sovereign debt arbitration process (Ruiz Diaz 2003; European Network on Debt and Development [Eurodad] 2009; Jubilee USA 2012) such as an international "sovereign debt tribunal" (SDT). The proposal for an SDT, as outlined by Christoph Paulus and Steven Kargman (2008), starts from the conviction that a statutory SDRM is ideal and desirable but not politically feasible at present. As such, the SDT proposal seeks to incorporate certain components of the SDRM without repacking the idea as a whole; namely, it looks to expand upon the SDRM's "Dispute Resolution Forum" designed to adjudicate disputes arising from the restructuring process.

According to its proponents, an SDT would have several advantageous features. First, it would be based on consensus among key stakeholders and would thus be perceived as fair and legitimate. The decision to subject restructuring disputes to an arbitration panel would be based on a contractual agreement between the sovereign debtor and its creditors and specified in the bond contract or debt instrument at the time of issuance — i.e., prior to any debt servicing difficulties. Second, an arbitration panel would serve as a neutral forum to resolve disputes between and among creditors and debtors. To ensure such neutrality, it would be important to establish the SDT under the auspices of a multilateral institution that is not itself a creditor. Paulus and Kargman (2008) consider the United Nations the most appropriate institutional home for such a tribunal. Third, an SDT would bind creditors and debtors to common solutions and thus overcome many of the collective action problems associated with sovereign debt restructuring. Finally, an independent arbitration panel could help build trust, confidence and legitimacy in the debt workout process by cultivating a general perception among sovereigns and their creditors that there is a "selected pool of expert arbitrators" who have the knowledge and experience to handle sovereign debt disputes (ibid., 5).[18]

The SDT would not, of course, have any authority to initiate and decide cases on its own. The tribunal would be granted such authority by way of a "prior contractual agreement to arbitration by all of the relevant parties" (ibid., 8). As such, it would be necessary to include arbitration clauses in sovereign bond contracts, much like CACs have been.[19] Such clauses would delineate the tribunal's jurisdiction and specify the event that would trigger arbitration. In purchasing these bonds, investors would be automatically agreeing to the contractual provisions contained therein, making any arbitration process binding for all parties.

17 For example, the IMF's role in the aftermath of the 1997 Asian financial crisis has earned it a poor reputation among many countries in East Asia. Most recently, failure to ratify the 2010 IMF reform package by the United States has put any governance reform of this institution on hold.

18 Several CSOs also advocate a specifically human rights-based approach to sovereign debt arbitration, whereby debt relief and debt restructuring negotiations reflect fundamental human rights concerns in the debtor country. (The authors thank Gina Ekholt of the Debt Justice Network Norway for reiterating the importance for most CSOs of a human rights-based approach to sovereign debt.)

19 It is important to note that while debtors and creditors must both agree to arbitration, prior contractual agreement is not in fact a necessary condition for such a process to take place. It may be seen as ideal to agree to arbitration beforehand, but, if they agree, creditors and debtors could also initiate an arbitration process during or after the outbreak of debt difficulties, including default. It is also worth noting that once it has been carried out, arbitration decisions are legally binding under the New York Arbitration Convention of 1958, to which 150 states are a party. (The authors thank Gina Ekholt of the Debt Justice Network Norway for bringing these important points to their attention.)

Proposals of the sort described above began to surface after the SDRM was shelved in 2003. While they have not yet been implemented or affected policy, there has been a recent revival of calls for the creation of an independent international arbitration process for resolving disputes arising from sovereign debt restructuring (Latindadd 2014; Jubilee USA 2012; Eurodad 2009). It is important to note that the SDT is but one model within the category of arbitration. Several variations have been proposed. One such proposal designed by Jose Antonio Ocampo (2014b), is to model an arbitration process on the World Trade Organization's dispute settlement mechanism, which would unfold in "three consecutive stages with clear deadlines": voluntary negotiations between the debtor and its creditors; mediation between the two parties; and, if the first two fail, arbitration. Recent reports note that the United Nations Conference on Trade and Development is about to unveil its own proposal for a new sovereign debt workout mechanism (Ellmers 2014).

### Issues for Discussion

- What are the pros and cons of the contractual, statutory and arbitration approaches, respectively?[20]
- Ostensibly, the statutory and contractual approaches seek to achieve many of the same purposes (overcome collective action problems, prevent individual bondholders from pursuing litigation, facilitate agreement on restructuring terms among a [super] majority of bondholders). What, then, are the real substantive differences between these two approaches? Why is one seen as more ambitious politically?
- Does the arbitration approach fall somewhere in between the statutory and contractual approaches? Which actors are likely to support and oppose each of these approaches? Why?

## NEW PROPOSALS FOR SOVEREIGN DEBT REFORM

In the wake of the euro-zone crisis, and in the midst of the Argentina litigation, a number of new proposals for handling sovereign debt restructuring have been advanced, including the IMF's recent proposal to reform its own lending framework.

20 It is important to note, as many have, that these different approaches to sovereign debt restructuring are not mutually exclusive. In fact, many advocate a multi-pronged approach that leverages complementary aspects of statutory, contractual and arbitration approaches. (The authors would like to thank Jurgen Kaiser of Jubilee Germany for reminding them of this important point.)

### The IMF and Debt Reprofiling

As mentioned, the outbreak of the euro-zone crisis, combined with the legal saga surrounding Argentina's debt obligations, has put sovereign debt restructuring among the IMF's top priorities. In June 2014, the IMF released a staff report suggesting a new approach to the Fund's "exceptional access" lending framework as it relates to sovereign debt restructuring. The report identifies key deficiencies in the Fund's current lending framework — brought into stark relief during the euro-zone crisis — and outlines a new institutional approach to managing sovereign debt crises.

Established in 2002 and amended in 2010, the current IMF framework for exceptional lending stipulates that in cases where there is a "high risk of international systemic spillover effects," a member's debt sustainability does not have to be assured with high probability to gain exceptional access to IMF resources (IMF 2010: 20). The wisdom of introducing this "systemic exemption" in 2010 has since been scrutinized, as critics argue that it undermined the framework's ability to constrain IMF lending decisions to the ultimate detriment of the Fund's legitimacy and ability to manage future crises (Schadler 2013). More generally, others called on the Fund to restore the "credibility and consistency of the policies underpinning its crisis-driven lending" (Boughton, Brooks and Lombardi 2014, 1). Whether or not the Fund heeded such criticism, the first major recommendation of the June 2014 staff paper is to eliminate the systemic exemption.

Once the systemic exemption is removed, the Fund is left with its 2002 framework, which states that in order to be granted exceptional access to IMF resources, a rigorous and systematic analysis must indicate with "high probability" that a member's public debt will remain sustainable in the medium term. If debt sustainability can be assured with high probability, the Fund will rely on its traditional approach: provide money to repay creditors with maturing debt obligations (i.e., to bailout creditors) as long as the borrowing country agrees to an economic adjustment program.

If a country's debt sustainability cannot be assured with high probability, however, it must undergo a debt restructuring sufficiently deep to restore sustainability before it can receive IMF assistance. As a consequence of this approach, "debt restructuring will be required not only in cases where there is a high probability of unsustainability, but also where it is not clear with a high probability whether the debt is sustainable or unsustainable; i.e., in cases where there is uncertainty" (IMF 2014b, 9).

As IMF staff now argue, the problem with this approach is that there are many cases in which considerable uncertainty exists (despite the increasing sophistication of the Fund's debt sustainability analyses [DSAs]); in these cases,

requiring a deep debt restructuring, which imposes steep costs on creditors and debtors, may be an unnecessary and suboptimal outcome. As such, in cases where the sustainability of a country's debt cannot be determined with high probability, Fund staff advocate an approach that relies on reprofiling debt rather than restructuring.

Under a reprofiling, there would be an extension of maturities on existing sovereign debt, but no change to the interest or principal. According to IMF staff, in cases of genuine uncertainty, reprofiling sovereign debt would be more effective than the current crisis management strategy for at least four reasons: it would be less disruptive to financial markets and less costly to debtors and creditors than a potentially unnecessary debt restructuring; it would be more effective and fair than allowing creditors with maturing claims to "exit" if a debt restructuring does indeed prove necessary; it would buy more time to implement necessary policy adjustments, better assess debt sustainability as those policies go into effect, and, in turn, reduce the likelihood of needing a restructuring in the first place; and since Fund resources would not have to be used to service maturing debt obligations, the IMF could support a more growth-friendly (i.e., less austerity-based) adjustment program with a greater chance of restoring debt sustainability (IMF 2014b).

In addition to genuine uncertainty, reprofiling would be conditional upon a member country already having lost market access; that way, reprofiling would not trigger a loss of market confidence. Fund staff also note the importance of securing broad creditor support for a reprofiling, and thus the need to implement reprofiling in a way that, if possible, avoids a payment default. Compared to the status quo, argue IMF staff, providing a greater role for debt reprofiling in the IMF's exceptional access lending framework will allow the Fund to better tailor its policy actions to the specific circumstances of a given country and crisis (IMF 2014b).

Overall, the Fund is seeking a broader range of policy tools for managing severe sovereign debt crises. To expand its tool kit, the IMF's staff will have to obtain the consent of its most powerful members. These include the United States and Europe, whose officials may worry that even reprofiling could threaten firms within their domestic financial markets. It also includes increasingly influential emerging powers such as China, whose officials do not see reprofiling as a particularly potent option (House, Wang and Xafa 2014). Even if the IMF adopts these proposals, there is no guarantee that the reprofiling option will be invoked.

The IMF's proposal is far from the only new idea for how to improve the handling of severe sovereign debt crises. In fact, the last few years have seen several new and innovative proposals. The following describes a few of the proposals that have received significant attention from scholars and practitioners.

## State-contingent Debt

Recently, the Bank of Canada and the Bank of England released a joint study outlining the equity and efficiency problems with the current approach to sovereign debt restructuring, and arguing that to address these problems "private creditors should play a greater role in risk-sharing and helping to resolve sovereign debt crises" (Brooke et al. 2013, 1). They propose the introduction of two complementary types of state-contingent debt — sovereign cocos[21] and GDP-linked bonds — both of which are extensions of the contractual approach. "Sovereign cocos," the authors explain, "are bonds that would automatically extend in repayment maturity when a country receives official sector emergency liquidity assistance" (ibid.).

By bailing in creditors in a transparent, predictable and credible manner *ex post*, cocos would ostensibly temper imprudent lending practices *ex ante* and thus reduce creditor moral hazard and the likelihood of sovereign debt crises erupting in the first place. In other words, since creditors would no longer be able count on full repayment by the official sector during crises, they would be more risk averse in their lending practices, in turn giving sovereign debtors less "rope to hang themselves" with. In the past, commitments by the official sector to bail in creditors have failed to reduce moral hazard because they lacked credibility. But the automaticity of the bail-in procedure specified in cocos would arguably make them more credible, and therefore effective, in discouraging imprudent lending and borrowing during normal times.

Furthermore, note Martin Brooke et al. (2013, 9), "the activation of sovereign cocos would significantly alter burden-sharing between private creditors and the official sector/taxpayers, reducing the required size of official sector emergency loans." Arguably, then, sovereign cocos would be more effective at preventing crises and more equitable in resolving them. And while sovereign cocos are apt to address liquidity problems rather than solvency ones, the activation of cocos can help to "buy time to make a fuller assessment of debt sustainability and, if need be, to undertake debt restructuring negotiations in an orderly way" (ibid., 9).

To optimize this contractual approach, Brooke et al. (2013) argue that sovereign cocos could and should be accompanied by GDP-linked bonds — that is, bonds that directly link principal and interest payments to the nominal level of a country's GDP (ibid.). GDP-linked bonds ensure, in other words, that when a country's GDP is reduced, so too are the principal and interest payments on its sovereign debt. Sovereign cocos and GDP-linked

21 "Coco" is short for contingent-convertible.

bonds are complementary insofar as the former helps tackle liquidity crises while the latter helps reduce the likelihood of solvency crises. As Brooke et al. (2013, 1) explain, "GDP-linked bonds provide a form of 'recession insurance' that reduces principal and interest payments when a country is hit by a negative growth shock," and this "helps to both stabilize the debt-to-GDP ratio and increase a sovereign's capacity to borrow at sustainable levels." GDP-linked bonds are not an entirely new idea, as a number of scholars have studied and highlighted the benefits from their introduction (Schiller 1993, 2003; Barro 1995; Chamon and Mauro 2005; Ruban, Poon and Vonatsos 2008).[22]

Both sovereign cocos and GDP-linked bonds are state-contingent debt instruments, meaning that they are defined as written into bond contracts at the time of issuance. In terms of political acceptability, this point is potentially important. While statutory arrangements (such as the SDRM) have historically failed to generate sufficient political support (Helleiner 2008), contractual mechanisms have at least some record of success. As Brooke et al. (2013) point out, the widespread adoption of CACs in the mid-2000s provides historical precedent for changes to the contractual terms of sovereign debt.

## Sovereign Debt Forum

Another new idea that has received some attention is Richard Gitlin and Brett House's proposal for a Sovereign Debt Forum (SDF). As a semi-formal institutional venue, the SDF would, in the words of its proponents, "provide a centre for continuous improvement of the processes for dealing with financially distressed sovereigns and a venue for proactive discussions between debtors and creditors to reach early understandings on treating specific sovereign crises" (Gitlin and House 2014, 7). The SDF would be a non-statutory body modelled loosely on the London and Paris Clubs, but with wider membership. Gitlin and House (2014, 7) argue that by providing "an independent standing body to research and preserve institutional memory on best practice in sovereign debt restructuring" as well as a meeting place for debtors, creditors, and other stakeholders, the SDF would help to facilitate timelier and more orderly resolutions of sovereign debt crises in a way that complements, rather than competes with, existing institutions and processes.

While sovereign cocos and GDP-linked bonds represent an extension and improvement of the contractual approach, the SDF breaks from the statutory-contractual dichotomy altogether. Indeed, Gitlin and House (2014, 7) argue that the world has been stuck between a rejected proposal for a statutory approach (the SDRM) and a working, but inadequate, contractual approach in the form of CACs. They argue that this impasse has resulted from a failure to accurately diagnose the main problems associated with resolving sovereign debt crises. Rather than holdout creditors or the propensity of sovereigns to default gratuitously, the core problem, as they and others see it, is that "sovereigns tend to delay restructuring their debts and, when they do pursue a debt treatment, they are often insufficiently ambitious in seeking to produce a debt burden that is sustainable" (ibid., 7). In their view, the SDF is thus well positioned to handle the issue of delay, since it provides "a venue for proactive discussions between debtors and creditors to reach early understandings on treating specific sovereign crises" (ibid.).

## Proposals from the Committee on International Economic Policy and Reform

A number of other notable ideas have surfaced, including a series of proposals put forward by the Committee on International Economic Policy and Reform, a group of prominent experts.[23] Similar to many others critics of the status quo, these experts argue that the current ad hoc approach to sovereign debt restructuring "provides poor incentives both ex ante and ex post" and should therefore be reformed (Buchheit et al. 2013b). They propose four potential remedies, ranging in ambition and geographical scope. The first two can be implemented unilaterally and, as such, are less ambitious than the latter two, whose implementation would require coordinated multilateral action by states.

The first proposal is to strengthen the existing contractual approach by adopting CACs with stronger aggregation features — CACs that give a supermajority of all bondholders, rather than just the holders of an individual bond series, the right to restructure against the will of a minority of holdouts. The effectiveness of this approach would ultimately "depend on the degree and speed of adoption of strong aggregation clauses in international debt contracts" (ibid., 44). Strengthening CACs to enhance bondholder aggregation would entail only a small amendment to the current approach, and so it would be relatively easy in both technical and political terms. This is indeed the approach that has so far been taken with the design and adoption of the new ICMA model CACs.

22 There may also be considerable problems with the idea of GDP-linked bonds. The most obvious relate to the questions of how GDP is measured and whether it is a good indicator of a government's capacity to service debt. (The authors thank Nathan Coplin for raising this issue.)

23 The Committee includes, in no particular order, Lee C. Buchheit, Anna Gelpern, Mitu Gulati, Ugo Panizza, Beatrice Weder di Mauro, Jeromin Zettelmeyer (these six were the lead authors of the report under discussion), Markus Brunnermeier, Barry Eichengreen, Mohamed El-Erian, Jose De Gregorio, Takatoshi Ito, Philip Lane, Eswar Prasad, Helene Rey, Dani Rodrik, Hyun Song Shin, Andres Velasco and Yongding Yu. Domenico Lombardi is now a member of the committee, but he was not when they published the report referred to and cited in this paper.

The second proposal also seeks to address the problem of holdout creditors, who have been emboldened by the success of non-participating creditors in the 2012 Greek restructuring and by the recent court ruling in favour of holdouts from Argentina's restructuring in the early 2000s. In spite of sovereign immunity, holdout creditors have managed to inflict collateral damage on sovereign debtors by threatening to interfere with payments being made by the sovereign to other creditors (third parties) under performing debt contracts. Thus, to "defang" holdouts, Buchheit et al. (2013b) argue that laws or regulations could be introduced in major financial centres in order to "immunize payments and clearing systems" from attempts to target third-party payments streams. This could be done in individual financial centres in isolation from one another (there would, arguably, be first-mover advantages in adopting this approach) or in multiple centres in a more coordinated international effort. However strong this approach could be in dealing with holdout creditors, it remains limited as a comprehensive solution to the problems of sovereign debt restructuring, for it does nothing to address the perverse incentives that contribute to unsustainable debt accumulation in the first place (that is, *ex ante* issues).

The third, and more ambitious, proposal addresses both *ex ante* and *ex post* concerns through the creation of a new sovereign debt adjustment facility to be housed in the IMF (ibid.). According to the Buchheit et al. (2013b, 32), the SDAF would serve two related purposes: "to create a stronger commitment device for the Fund not to be drawn into bailing out countries whose debts are likely unsustainable unless these countries also restructure; and to protect countries that undertake orderly restructurings in the context of the SDAF from holdouts."

To achieve the first goal, the IMF would establish criteria to determine the eligibility of a country for SDAF assistance. Countries that qualify for, and want, this type of assistance would "not have access to IMF crisis lending except under the SDAF" (ibid., 32). If a DSA by the IMF indicates that the debt burden of a country is unsustainable in the absence of a restructuring, then IMF lending to that country will be made conditional on a sovereign debt restructuring that provides sufficiently deep debt relief to restore long-term debt sustainability. To achieve the second goal, the assets and revenue streams of all IMF members could be effectively immunized from interference by holdout creditors. This proposal is certainly more ambitious and seemingly more difficult politically, for it involves coordinated multilateral action and, ultimately, an amendment of the IMF's Articles of Agreement. Still, the authors argue that the required amendment would be "minor," while the SDAF's impact in resolving the problems of "too little, too late" restructurings and holdout creditors could be major.

The final and perhaps most politically ambitious proposal is the creation of a European Sovereign Debt Restructuring Regime (ESDRR) — a statutory approach of limited geographical scope. In the midst of the euro crisis, euro-zone member states created the European Stability Mechanism (ESM): an intergovernmental organization designed to provide financial assistance to euro-zone members in times of need. Rather than create a new legal entity, the authors suggest that the ESDRR could be made an institutional feature of the ESM and brought into existence through a simple amendment of the ESM treaty.

The conditions under which the ESDRR would trigger or facilitate a debt restructuring would be guided by the existing European fiscal framework: "At debt levels below 60 percent [of GDP], ESM lending would be largely unconditional; but at 60 percent plus x (an upper threshold), ESM lending would be conditional on debt restructuring" (ibid., 44). Such a framework would provide a credible commitment to restructuring, thus reducing creditor and debtor moral hazard while still providing sufficient flexibility to account for large economic shocks. As the authors argue, "the euro area has both the largest need and the best chances" to implement such a comprehensive solution (ibid.).

It is worth noting that, for many — but not all — experts, there is a trade-off between the ambition — or the perceived political feasibility — of a given reform and its overall effectiveness. The more ambitious proposals, if implemented, would arguably go further in solving the underlying problems associated with sovereign debt crises and restructurings. The comparatively less ambitious proposals — i.e., those that would be easier to obtain political support for — would still represent an improvement over the status quo, but would not be comprehensive enough to robustly address all of the key problems associated with sovereign debt restructuring.

## Issues for Discussion

- From both a political and an economic point of view, how could the pros and cons of the various proposals on the table be assessed?
- Does the IMF's proposal go far enough toward resolving the core problems associated with sovereign debt management and sovereign debt restructuring?
- If debt reprofiling would have a similar effect as sovereign cocos, which approach is preferable and why?
- Are the most ideal or desirable proposals also politically feasible? Going forward, how should the balance and/or tension between political, economic and legal concerns be mediated?

# CONCLUSION

The purpose of this paper has been to provide an overview of the main issues, debates and policy proposals that surround sovereign debt restructuring. While it seeks to be relatively comprehensive in its treatment of these items, the paper is in no way exhaustive of the many possible ways of preventing and managing sovereign debt crises. A few of the most prominent reform proposals — namely, those that have gained considerable attention within scholarly and policy circles — have been discussed in this paper, but several other possibilities exist,[24] whether or not they have yet been considered. This paper is thus intended to serve as a starting point, the beginning of a broader conversation that will engage with and take us beyond the current debate and menu of options for dealing with the complex equity and efficiency problems that so often mire sovereign debt restructurings. Only through inclusive discussion and debate of this sort can we hope to move toward sovereign debt restructuring arrangements that work for all.

## Issues for Further Discussion

Our ongoing consultations with various stakeholders point to a number of important issues that go beyond the scope of this paper, but that nevertheless deserve considerable attention going forward. First, there is room for further learning from detailed case studies and comparative research on sovereign debt restructurings. While case studies of selected past defaults and debt restructurings do exist (see Sturzenegger and Zettelmeyer 2006), there are still several new and previously underexplored cases that warrant greater attention.[25]

Second, there is need for further discussion and analysis of the role of domestic laws, jurisdictions and judicial action on sovereign debt restructuring. Argentina's ongoing saga highlights the importance of domestic law within the United States — more specifically, the state of New York — but it also opens up a potential avenue for addressing sovereign debt problems: amending national or subnational laws in key financial hubs. This approach is not entirely novel. In 2010, the United Kingdom passed the Debt Relief (Developing Countries) Act to prevent holdout creditors from using UK courts to sue HIPCs for debt repayment. Although this act is limited in scope,[26] it provides a useful example of how local legislative changes in key jurisdictions can go a long way in addressing global problems.

Third, more attention should be given to the role of international investment agreements (IIAs) in sovereign debt restructuring. In a short article on this topic, Kevin Gallagher (2012) discusses how "sovereign debt restructuring is seen as grounds for private bondholders to file arbitral claims under IIAs," notes that "safeguards under IIAs are limited," and warns that "if claims against sovereign debt restructuring become more widespread they could threaten the already fragile regime for financial crisis recovery." Research on the role of IIAs in debt restructuring is still in its infancy, but the early work of Gallagher and others suggests that this is a crucial area of inquiry and future action, especially if trade and investment agreements continue to multiply.[27]

This paper has outlined the issues at the heart of sovereign debt restructuring and the main proposals for improving crisis prevention and management in this crucial area with the aim of facilitating the global consultations. These proposals, as well as the underlying assessments they are based on, are the subject of serious debate and discussion among scholars, policy makers, CSOs and private market actors. In other words, this paper frames the broad parameters of the current debate over how best to govern sovereign debt restructuring. Understanding, engaging with and advancing this debate are the necessary first steps.

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24 For another interesting proposal, see Paris and Wyplosz (2014).

25 For a list and detailed table of past debt restructurings since 1950, see Das, Papaioannou and Trebesch (2012).

26 The act applies only to HIPCs and will expire with the HIPC Initiative.

27 The Comprehensive Economic and Trade Agreement (CETA) between Canada and the European Union contains provisions related to sovereign debt restructuring. See page 184 of CETA, available at http://trade.ec.europa.eu/doclib/docs/2014/september/tradoc_152806.pdf.

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