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Sovereign Debt Restructuring Mechanisms--Unintended Consequences of the 2002 IMF Proposal

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Abstract

The IMF's 2002 proposal for a new Sovereign Debt Restructuring Mechanism (SDRM) attracted considerable criticism from both emerging market sovereign debt issuers and from private sector financial institutions. This paper outlines the features of the SDRM and its advantages as perceived by the Official Sector. The paper explains the criticisms levelled by emerging market and private sector players. It analyses the likely market responses of lenders in the period prior to any threated filing under the SDRM and shows how these responses are likely to reduce lending to risky sovereigns and to provoke earlier defaults. With such responses, the expected benefits of any SDRM in terms of the reduction in the frequency and severity of sovereign crises are likely to evaporate.

a. This paper was originally completed in November, 2002. While it was not published at the time, it entered the literature through private circulation (see Barry Eichengreen, "Restructuring Sovereign Debt", *Journal of Economic Perspectives,* Vol 17, No 4, Fall, 2003, p 91) The proposal for some form of SDRM has attracted recent interest. See, for example, *The Economist*, November 4th, 2010 and Beatrice Weder di Mauro & Jerome Zettelmeyer, "European debt restructuring mechanism as a tool for crisis prevention", VoxEU, 26 November, 2010 (http://www.voxeu.org/index.php?q=node/5845) Given this interest, making the paper again available seemed useful. The paper is reproduced here as originally completed with minor editorial corrections, plus the Abstract.

b. The author was the Senior Executive Vice President, Global Risk (Chief Risk Officer) of The Bank of Nova Scotia, Canada. He served as a member of the committee of international bankers that structured and negotiated the Korean debt restructuring in 1998. He is currently an Adjunct Professor of Economics at the University of Toronto.

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1. Introduction

The International Monetary Fund, with the support of the G7 sponsors, has launched a proposal to provide a new mechanism for sovereign governments to restructure excessive levels of indebtedness. [1] This initiative is in response to the unpredictability and costs associated with current mechanisms for sovereign restructuring.

Under the proposal, a new Sovereign Debt Restructuring Mechanism (SDRM) would be established within the framework of the IMF. It would allow financially stressed countries to invoke a stay during which no international creditors of the sovereign would be able to bring suit for repayment of debt. The stay would extend for a defined period of time during which negotiations would be undertaken to restructure the sovereign's obligations to make the debt burden sustainable. The SDRM would contain voting procedures under which a supermajority of debt holders would be able to approve a proposed debt compromise and thereby bind any small majority of creditors who wished to hold out for a better deal.

The response by emerging market debt issuers, by investors and by other market participants has been striking in both its negativity and its unanimity. Despite the apparent attractiveness of the logic behind the SDRM, both issuers and investors have questioned the need for any new mechanism. They have pointed to the success with which restructurings have taken place in the past. They have raised concerns about the new complexities that will be introduced by the proposed SDRM. They have seriously questioned whether the claimed improvements to the predictability and fairness of international debt restructuring under SDRM will be achieved. Both investors and emerging market issuers have argued that the proposed mechanism will led to increased costs of borrowing and potential restriction of market access for emerging market entities.

Private sector initiatives have instead focused on implementing Collective Action Clauses (CAC's) in bond indentures, clauses that would allow debt compromise by less than the 100% favourable vote now required in many indentures. By easing the voting threshold to a

supermajority, the ability of hold-out creditors to block a restructuring that is in the interests of both the majority of investors and the sovereign would be curtailed.

Both these proposals, the SDRM and the proposed changes to bond indentures through CAC's, suffer from technical difficulties in their current form. Work is on-going to remedy these deficiencies.

The IMF and the G7 governments have welcomed work on CAC's by the private sector. They have argued that the SDRM and the proposed CAC's are complementary initiatives. [2] Were CAC's to become widespread, overextended sovereigns would have an avenue for consensual restructurings short of a formal filing, lessening the likelihood that the SDRM would be used. The SDRM would then be available as a last resort.

This claimed complementarity of CAC's and the SDRM, however, has been widely questioned by private sector participants and by emerging market issuers. Their view is that both mechanisms are attempts to solve the same problem and that there is no need for both to be pursued simultaneously.

The purpose of this note is to provide some framework for understanding the reasons for such divergent views between the G7 and the IMF on the one hand and the representatives of the private sector and emerging market issuers on the other.

2. The Official Position

The SDRM is presented by the IMF and the G7 spokesmen as a reform that is essential to improve the functioning of the international financial architecture. [3] This position is supported on two grounds.

First, the IMF has faced difficulties in performing its role as lender of last resort to sovereigns that are facing severe liquidity strains. A decision to decline further support often

leads to a prompt and full-blown financial crisis for the country in question. This usually entails a unilateral suspension of payments and implementation of exchange controls. Considerable hardship is visited on the sovereign's economy through such a crisis, impairing its future ability to repay its debt. When a rapid agreement on debt restructuring is not forthcoming, creditors can use the courts in developed countries to disturb the sovereign's financial and trade dealings in world markets, provoking more hardship for the country. Faced with such a prospect, the IMF has found it very difficult to turn aside requests for further support from sovereigns facing financial trouble, even when it is questionable whether the contribution of further official funding will assist in ensuring a viable longer-term solution. The IMF support to Argentina in the year or two before its crisis in 2001 is a prime example of such difficulties.

The IMF has therefore proposed the SDRM as a mechanism that would provide an alternative to further official support when a sovereign's debt burden appears too heavy to be sustainable. A stay period for the sovereign's private debt issued under foreign law would be provided during which negotiations for a restructuring of that debt would be conducted. All creditors would be put into one or more broad classes. Approval of a restructuring proposal would be by super-majority, solving the hold-out creditor problem. The structure would also provide a means for the sovereign to borrow from the private markets on a priority basis – one senior to its existing debt – to provide for day-to-day needs during the stay while restructuring negotiations proceed. The IMF views such a system as being far more predictable and efficient than the current mechanisms.

The IMF draws the parallel with domestic insolvency laws such as *Chapter 11*, and asks rhetorically why one would not wish to see a parallel implemented for sovereign countries.

The introduction of a SDRM offers the IMF an elegant way to handle a request for funding from a country whose debt has probably become unsustainable. In refusing a further borrowing request, the IMF could point the sovereign to the mechanism and suggest that the proper procedure is to seek a negotiated compromise with debt holders. In the IMF's view, the unpredictability of the current system would be avoided and the potential for a hung negotiation with investors substantially reduced. As a result, the IMF would be able to shed much of today's

pressures for excessive lending into distressed situations. This would result in a significant saving of scarce official resources.

3. Views of Issuers and Investors.

On its face, the argument of the IMF and the G7 countries appears persuasive. Since private sector participants are viewed as being the main beneficiaries of the SDRM, the strong rejection of the proposal by issuers and investors calls for explanation.

There are a number of strands to the counter argument from the private sector.

First, over the past few years successful restructurings have taken place in virtually all cases of sovereign default – often relatively promptly. The private sector has been very imaginative in developing new techniques such as exchange offers and exit consents through which a number of restructurings have been successfully completed. [4] The private sector has been adept at understanding the political and economic realities of their sovereign borrowers and at recognizing the advantages to investors of a rapid and successful restructuring. Most sovereigns have understood the need for a rapid resolution of their problems to ease their re-entry into international debt markets. Willingness on both creditor and debtor sides has normally led to fairly rapid negotiated solutions. Because of the private sector's record of success, many commentators contend that the need for a new restructuring mechanism has not been demonstrated.

The IMF has made much of the potential difficulties posed by rogue creditors using the courts to enforce full payment of unpaid indebtedness and thereby to inhibit a negotiated restructuring. Private sector commentators have responded to this argument by pointing out that in fact rogue creditors have rarely inhibited negotiated restructurings. The risks they pose arise partly as a result of ill-advised court judgements. The appropriate corrective action to this problem is either to appeal the decision or to change the applicable law to clarify its intent. The risks also arise because of the requirement in many bond indentures for a 100% favourable vote

by debt holders for any changes to the terms of the debt. This is the problem that CAC's are designed to handle. In summary, many private sector commentators view the use of the SDRM to address the rogue creditor problem as being an inappropriate and excessive response to rather narrow legal risks. [5]

Second, many point out that the SDRM, as proposed, is limited to the private debt of sovereigns issued under foreign law. It would therefore not have been applicable to a number of recent cases, including those of Korea and Brazil, where the debt that needed to be stayed and restructured was primarily issued by private sector companies and institutions. As a result of this limitation in scope, the SDRM promises to be of use in significantly fewer cases than is apparent on the surface.

Third, many raise a fundamental objection to the analogy with private sector bankruptcy legislation. There is a major difference between private company insolvency and a sovereign debt restructuring. While companies are subject to national laws and regulation, the sovereign is not. It is just that – sovereign. It is not subject to any rule of law but its own. This fundamental difference means that the metaphor of *Chapter 11* breaks down in several critical respects.

To begin with, the result of unsuccessful compromise negotiations under *Chapter 11* is a wind-up under *Chapter 7.* The US Trustee takes over the proceedings. In contrast, under the SDRM the result of unsuccessful negotiations is a cessation of the stay. The fundamental control of the process reverts to the sovereign. While the subsequent loss of reputation and problems with future market access can be severe, the sovereign retains the freedom of managing its affairs – not its debtors and not a trustee. In short, the sovereign retains ultimate tactical control over the course of the proceedings. This is a phenomenon that has no parallel under *Chapter 11*. The current actions of the government of Argentina provide a clear example of this underlying reality.

The SDRM lacks a number of the features of *Chapter 11* that protect the rights of creditors. These include criteria for access to a filing, concepts of adequate protection, creditors' committees with powers of investigation, and the like. The SDRM is conceived almost solely as

a mechanism for instituting a stay along with a set of voting mechanisms for confirming a compromise or for ending the stay. As a result, the range of judgemental issues that are so frequently the subject of submission by various parties to the *Chapter 11* court is simply missing from the SDRM. Their omission heightens investor fears that considerations of equity and due process will not receive adequate attention under SDRM.

In a fundamental sense, the nature of the compromise in a sovereign restructuring is different from that of private sector insolvency. The private company has a cash flow and has assets. The object of the procedure is to protect value and to divide up the result. In contrast, the sovereign has a net cash flow that is the result of domestic political bargains relating to public sector expenditures and tax revenues. The ultimate compromise therefore has two elements – one is a domestic political compromise relating to a willingness to cover debt servicing obligations, the other is a compromise between the sovereign and its creditors. There are therefore two complicated but interrelated sets of negotiation – a stark contrast with private sector insolvency. The concept of "sustainability" of debt is intimately linked to the extent of political will to repay obligations. [6] This has no parallel in *Chapter 11*. Investors therefore fear that the introduction of SDRM will weaken their strength in achieving a favourable compromise at the political level within the sovereign to provide for an adequate level of debt service.

Much of the distaste among investors for SDRM stems from the belief that it will diminish the cost of declaring a debt crisis for the sovereign. It will provide a sense of legitimacy for a debt compromise request. This legitimacy is sanctioned by a mechanism instituted by the IMF and the G7. This very legitimacy will be seized upon by domestic political parties within heavily extended sovereigns and will be used to weaken the will of the governing parties to resist the opening of restructuring negotiations. As a result, many private sector commentators expect that the mere introduction of the SDRM will lead to an increase in the number of sovereign restructurings.

There is also concern about the proposed availability of new funding. This funding will benefit from a senior position ahead of debt outstanding at the date of the filing for the stay under SDRM. The IMF's proposal does not suggest any clear limitation on the extent of such

financing. [7] It states that such funding could be used to provide for trade finance purposes. [8] Since most trade finance is private and therefore outside the ambit of the SDRM, international banks are likely to seek to have their short-term exposures to the private sector repaid as they mature. Financing of the foreign exchange requirements could be funded by drawdowns on the sovereign's new priority funding. The proposed mechanism could therefore see short term creditors repaid from new funding to the sovereign that ranks ahead of the sovereign's bond debt. Such a prospect will not be attractive to existing bond holders.

At the same time, investors recognize that the voting thresholds for the acceptance of a successful proposal under SDRM present a significantly easier set of hurdles than current bond indentures. Indeed, that is one of the main objectives of the SDRM. As a result, the level of negotiated compromise achieved in given restructurings may be expected to increase following the introduction of SDRM.

All these considerations lead to the conclusion that the SDRM will lead to a higher incidence of default and to higher levels of loss on sovereign debt of developing countries. While the mechanism may in certain circumstances lead to value preservation, most of this advantage will be captured by sovereigns to the detriment of investors.

Issuers have also expressed concerns. Those sovereign issuers that have strong intentions of repaying their debt despite the servicing burden will be presented with a further problem with SDRM. Once the SDRM is in place, such countries will find it more difficult to give a credible commitment not to seek a debt restructuring. Investors faced with a statement by a sovereign that it will not avail itself of recourse to the SDRM could place little faith in such an assurance if there are net benefits to debt relief that are available through the use of the mechanism. In effect, the introduction of the SDRM will shift rights away from these solvent but financially stressed sovereigns who wish to avoid a debt compromise and towards sovereigns who decide to file under the SDRM. The proponents of SDRM have not yet argued whether this shift of rights as between sovereigns should be viewed as equitable.

A number of the larger emerging market sovereigns have issued warnings that the IMF should be vary wary of proceeding down the path of the SDRM. [9] While they recognize that the mechanism may have advantages in certain circumstances, they have concerns that centre on the impact of SDRM on issues such as debt cost and access to capital markets – precisely the areas of concern to international investors. The overall conclusion about the advisability of proceeding with the SDRM parallels that expressed by many investors.

4. SDRM in a Dynamic Context.

The apparent strength of the IMF's rationale for the SDRM depends on the direction of its argument. The logic runs from a view that the current environment for restructurings is somewhat costly and unpredictable to a conclusion that the SDRM will improve predictability and equity. While this argument is reasonable as far as it goes, it is strictly a static analysis. It presupposes that there will be no adverse reactions by issuers and investors that over time will defease or arbitrage away the potential impact of various features of the SDRM.

To make a convincing case for the SDRM, then, a further piece of analysis is required. One must run the logic in the opposite direction and begin with the proposition that the SDRM exists. The analysis must ask what incentives and risks are created for issuers and investors by the SDRM, and how these players are likely to react to the set of incentives. A clear look must be taken at the ways in which these risks can be defeased by the players, and the problems that such defeasement will cause for predictability and equity in restructurings. One must also look at potential second-order problems caused by a filing under the SDRM and for other debt of the sovereign and its agencies that is not covered by the SDRM.

In essence, this analysis must concentrate on estimating the effects of the law of unintended consequences. The resulting analysis should then be used to take a fresh look at the risk-adjusted net benefits promised by the SDRM.

5. SDRM Incentives for the Sovereign Borrower.

While the SDRM will add a new set of opportunities for a financially stressed sovereign, it removes none of its ultimate tactical options. In particular, the sovereign will always retain the options of declaring a moratorium and instituting exchange controls. All negotiations with its investors, whether prior to the institution of a stay under the SDRM or whether during such a stay, will take place in the shadow of this ultimate reality.

As the financial situation of the sovereign worsens and the decision has been taken to consider a restructuring of its debt, how will the sovereign view the option of seeking a stay under the SDRM?

For many countries the use of the SDRM may present a more comfortable option than continuing to resist a restructuring. [10] First, the country will have the possibility of obtaining priming loans under the SDRM, [11] an option that may not be available under current structures. The potential for obtaining access to new liquidity is an especially attractive feature of the SDRM. Second, with lower voting thresholds, a favourable vote on a significant debt compromise may be more likely than under the current options of exchange offers or votes under bond indentures. [12]

The SDRM presents a further set of opportunities. In view of the high costs imposed by credit markets on countries that default, under current arrangements most stressed sovereigns will delay default until they have no acceptable alternative. In contrast, once the SDRM is available, the sovereign will be able to consider a filing at an earlier stage. Priority financing could be available to cover liquidity shortfalls. This flexibility in timing parallels the option that is available to companies and avail themselves of debtor-in-possession loans. With greater flexibility for timing the declaration of intent to renegotiate, the sovereign will be able to maximize liquidity by drawing down on all other available sources of funding prior to the filing.

This increased flexibility for the timing of the imposition of the stay will also put the sovereign into a position to implement the stay before the point at which the flight of short-term funds that is typical of today's sovereign crisis. [13]

The proponents of the SDRM have argued that this 'value preserving' feature of the SDRM will improve the amount of resources available to repay creditors and therefore improve the losses on default. However, since these 'value preserving' features reflect the entrapment of more debt within the restructuring, they represent pure redistributional effects and provide no value for society as a whole. Moreover, this 'capital preserving' advantage for sovereigns will exist only if institutions in short term markets fail to recognize their risks. Such wilful ignorance by private market participants seems highly unlikely. The result of this greater borrower flexibility in choosing the timing for beginning the negotiations will be a significant decrease in the predictability for investors in the timing of the onset of a restructuring.

6. Investor and Lender Reactions to the SDRM

Investors and lenders are not passive. They will rapidly assess any risks and opportunities introduced by the SDRM. They will act on this assessment in their underwriting and trading decisions. Private investors and lenders will, of course, understand the implications of a potential early filing and will react to defease this risk. In the current pre-SDRM period, there is a fairly high likelihood that a stressed sovereign will do everything possible to avoid a moratorium because of the costs involved. Investors are therefore able to watch movements in economic aggregates and the balance sheets of the key players including the sovereign and the central bank. The level of foreign exchange reserves is particularly important. In the case of Argentina, for example, data on the levels of foreign exchange reserves and on a wide variety of bank deposits were available from the Argentinian central bank on a daily basis over the internet. Such data are used by investors and lenders to judge just how close to the brink the sovereign really stands.

With the introduction of the SDRM, investors and lenders will find it more difficult to judge the point at which the government will take the political decision to declare its debt to be non-sustainable and to suspend its payments. In this respect, the SDRM will introduce a very significant new element of unpredictability.

Those lenders who have an ability to react at short notice – providers of trade credit, inter-bank funding, off-balance sheet transactions and other short term accommodation – all have an ability to bring down their exposures as conditions in the country worsen and risks rise. The introduction of SDRM will simply advance the timing of this run-down in exposures – it will do nothing to impede it. [14] The sharp decline in the levels of commercial bank exposures in emerging markets over the past four years is a clear indication of the scale of the reaction by private institutions when they turn against risks that they consider excessive.

The most probable result is that the 'capital preserving' features stemming from the sovereign's increased flexibility of timing for declaring the onset of negotiations will be completely undone through market anticipation of the potential for an early move by the sovereign. In other words, the introduction of the SDRM will not ultimately give the sovereign any advantage in controlling the timing of the crisis that cannot – and will not – be undone by reactions in the market. The only result will be an increase in the unpredictability of timing and an earlier provocation of the cessation of payments.

One serious outcome of this increased unpredictability is a likely growth in the number of sovereigns that are forced to declare a default by an early drain of nervous short term funding. If sovereigns make more use of the SDRM than is strictly required, or if short term lenders over-shoot in their reactions to the threat of potential filings, the introduction of the SDRM will provoke an increase in the number of crises and the number of required financial restructurings. The resulting risks to the flows of international capital are extraordinarily difficult to assess.

This pattern has implications for the IMF. The sovereign whose country faces a drain of liquidity by the market at an earlier stage than is the case under today's arrangements will undoubtedly turn to the IMF for funding to tide it over its liquidity problems. As a request will

come at an earlier stage in the country's financial deterioration than is the case today, the case for IMF funding would be stronger. As a result, the introduction of the SDRM is likely to do nothing to solve the IMF's expressed difficulties in turning aside requests for support and in conserving scare official resources. Indeed, it is likely to increase the frequency and size of the requested financial assistance packages.

Longer term investors may also react to the possibility of the imposition of an SDRM stay. While the calculation of specific tactical advantage will vary enormously from situation to situation, there will be ample opportunities for asset trading. To give an example, if an investor holds direct debt of the sovereign, he may wish to swap this exposure for debt of a government agency that owns significant assets and is not subject to a stay under the SDRM. At the same time, an indigenous financial institution may be prepared to purchase the sovereign debt knowing that the degree of compromise for domestically held government debt will be limited by the need for the sovereign to ensure that its banking system remains solvent. [15]

This type of shift will reduce the proportion of the debt subject to the SDRM, thus reducing the likelihood that a restructuring of the sovereign's private international debt through an SDRM stay alone will be sufficient to render the debt burden sustainable.

These types of trade are likely to take place well before a filing under the SDRM may be expected. As a result, the sovereign can anticipate that there will be a significant shift in the composition of the group of debt holders during the run-up period to a possible filing under the SDRM. Such shifts will parallel similar patterns of behaviour seen before filings under *Chapter 11*. In effect, more of the indebtedness will become held by investors making a 'play' on a potential filing. There will be a reduction of the debt in the hands of longer term strategic investors. Such shifts in the composition of the various groups of creditors can have a major impact on the restructuring negotiations. As a result, no conclusion can be drawn about wither the SDRM will improve the predictability of the reactions of creditors or improve their willingness to reach a rapid compromise.

Once an SDRM stay is in place, the best outcome overall will be a successful debt compromise that results in a sustainable debt burden and the re-entry of the country into financial markets. Such an outcome avoids the high costs of a long period of debt moratorium and exchange controls with all the dislocation and economic dead loss for the country consequent on such an outcome. The result is an improvement in the country's ability to repay debt.

While the overall benefits of a quick and successful negotiation are clear, each party to the negotiations will conduct itself solely with a view to maximizing its own recovery. In other words, distributional issues become as important as overall value preservation. The sovereign will propose as favourable a compromise as it thinks it can get away with, and will argue that a failed negotiation will cost creditors severely. On the other side, there will always be some creditors who believe that the sovereign has more to lose from a failed SDRM negotiation than they do. This may be particularly the case for those 'vulture investors' who have bought into the debt at cents in the dollar and have a relatively small portion of their assets tied up in the investment. They appreciate the costs to the sovereign of prolonging negotiation and often believe that a creditor hold-out threat will force the sovereign into a more accommodative stance.

There are two features of the SDRM that support such a view of hard line investors. First, the initial stay period is very short – only 90 days – and prolonging it takes a favourable vote by a high percentage of creditors. As a result, the threat to cut short the SDRM stay may be very credible. Second, if the negotiations under the SDRM fail, negotiations will fall back to the options currently in place, including exchange offers and other mechanisms. Investors know that once the sovereign decides that it wishes to do a reasonable deal, it will be able to do so. Voting under the mechanisms available today may be seen by investors as more favourable to their interests. Such investors may reasonable conclude that a vote to drop the SDRM stay will leave them with ample mechanisms to achieve a negotiated or exchange settlement with the sovereign, and the sovereign will be forced to be more accommodative than under the SDRM. [16]

There is a danger that the implementation of the SDRM will lead to a wider gap in the expectations between sovereigns and investors about what is achievable in debt compromise. Particularly in the early period after the implementation of the SDRM, many sovereigns will be

tempted to overestimate the gains they can make in negotiation with their creditors. A number of failed negotiations under the SDRM stay will therefore be likely.

Any failure of negotiations for a particular sovereign will lead to further shifts in the composition of the creditors' group as still more investors shed their interests to 'vulture investors'. This can only increase the difficulties of future negotiations. Such patterns will serve to prolong the problems, increase the costs of economic dislocation and ultimately deepen the burden on the crisis economy.

Much has been made of the value preserving features of the SDRM. Such a benefit will accrue only in those cases where the SDRM makes a difference between a successful early compromise and a prolonged crisis. This analysis suggests, however, that there may be a significant number of cases where investors be simply unwilling to reach a rapid compromise under the voting regime of the SDRM. In such cases, creditors will use their votes at the earliest point to suspend the stay and continue negotiations under today's more creditor friendly regime. The SDRM stay will simply act to prolong the crisis. It therefore brings with it a significant potential for value destruction.

This analysis leads to several conclusions. First, the SDRM will increase the uncertainties faced by investors trying to gauge the risks of a sovereign deciding to seek a debt compromise and the likely timing for such a step. The result will probably be an increase in the number of cases where short term investors, seeking to protect their position, begin an early liquidity run that causes a crisis. Second, the degree of compromise that can be engineered by the sovereign through the use of the SDRM – if indeed such a compromise is achievable – is likely to be higher than in today's environment. On balance, value destruction seems the most likely outcome. Third, as a result, the SDRM is likely to lead to an increase in the cost of capital for emerging markets and a reduction in both availability and liquidity. Finally, no *a prior* judgements can be made about whether on balance the SDRM will led to value creation or destruction in sovereign debt crises.

7. Coverage of SDRM and Opportunities for Arbitrage

For an SDRM to be of broad use, it must be effective in allowing a compromise across a significant range of a country's debts. The range of debt must be broad enough that the debt burden will be rendered sustainable once the compromise has been completed. It must also be broad enough that the participants, when comparing their proposed compromise with that of other creditors who are not compromised, are satisfied with the level of equity provided. If significant portions of debt are excluded from compromise, there will be strong resistance to the proposed restructuring from those who are being asked to accept its terms.

The IMF's proposal, in its current form, applies only to the sovereign's private debts established under foreign law. It does not apply to obligations owing to the IMF, multilateral development banks and by-lateral loans from other governments (the Paris Club debt.) [17] Nor does it apply to indebtedness of agencies and subsidiaries of the sovereign. Moreover, the SDRM does not cover private sector international indebtedness, often a significant contributor to the excessive debt burden of a country.

The advantages to the IMF of structuring the SDRM in this form are significant. Though restricting the focus of the SDRM to a narrow range of the sovereign's debt, the IMF avoids the need to establish a formal bankruptcy court. The only new institution that is required is an arbiter whose role is limited to declaring a stay at the sovereign's request, to proving the claims and to monitoring voting procedures.

The disadvantage of this arrangement lies in the fact that much of the foreign debt that gives rise to the excessive debt burden may be owed by government entities other than the sovereign and by the private sector. The Korean crisis of 1997-1998 was a crisis of short term commercial bank debt, with virtually no sovereign debt outstanding. The solution, nonetheless, lay through a restructuring organized by the Republic of Korea, with the exchange debt guaranteed by the Republic. Such private debt is not amenable to restructuring under the SDRM proposed by the IMF. This limitation substantially reduces the range of crises for which the SDRM could be of assistance.

If the sovereign's direct private indebtedness subject to a stay under the SDRM represents only a small part of the country's total foreign debt, trying to restructure this sovereign debt under SDRM will result in one of two awkward outcomes.

First, the amount of compromise to the sovereign's private indebtedness required to render the country's overall debt burden sustainable could well be such a high percentage of the sovereign's private debt that severe problems of equity arise. The burden of the debt compromise is shouldered exclusively by private debt holders of the sovereign while other creditors of the sovereign receive full repayment. The necessary super-majority of the sovereign's debt holders may simply refuse to go along. In other words, use of the SDRM by the sovereign as the single tool to seek compromise would be a highly risky strategy.

Second, the sovereign could seek to use the SDRM in conjunction with informal negotiations for non-SDRM debt without declaring any stay or moratorium beyond the SDRM. Individual classes of SDRM-stayed creditors would undoubtedly condition their approvals upon acceptable and successful outcomes in each of the other major sets of negotiations. The ultimate objective of the sovereign would be to achieve compromise sufficient debt to render the country's overall debt burden sustainable.

Such a negotiating strategy would be extremely risky. It would allow short-term trade and other creditors to the private sector to require repayment of their debt as it became due. It would expose the sovereign to the strong likelihood of rogue creditors seeking court orders for repayment of matured or cross-defaulted debt not covered by the SDRM. Bringing each one of a series of simultaneous negotiations to successful conclusions that is acceptable across the broad range of creditor groups would be extremely difficult. As a result, it is very unlikely that any sovereign would attempt such an approach. Much more likely is a moratorium combined with a filing for a stay under the SDRM, along with the imposition of foreign exchange controls. Negotiations would take place following this coordinated set of actions. In such a case, the SDRM could not serve to prevent the more generalized crisis and related exchange controls.

Even in cases where the sovereign's direct private debt forms a sufficiently large proportion of a country's foreign obligations that a compromise will produce sustainability, use of SDRM as the sole vehicle for organizing a restructuring is likely to be impractical. Many countries issue debt through government agencies. Often such debt is effectively cross-defaulted to the government's debt or debt ratings. In such cases, a filing by the sovereign under the SDRM would trigger a cross-default and hence accelerate this other debt. The sovereign would then be faced with multiple simultaneous negotiations – along with the problem of rogue creditors – even when it employs the SDRM. Again, in such circumstances the likely first step in negotiations would be the imposition of a package containing a moratorium and exchange controls along with an SDRM filing. The existence of such patterns of linked ratings and of cross-default and cross-acceleration between sets of government and quasi-government debt will reduce the likelihood of the SDRM being effective as a tool to ward of a general moratorium.

All of these considerations suggest that the cases in which the SDRM could be used as the single tool for organizing a restructuring are very limited. Larger sovereigns with complicated external balance sheets are likely to make use of the SDRM only as one of several tools for organizing their restructuring. The cases where the SDRM could in practice play the key role in organizing the process may be restricted to smaller countries where the bulk of the debt has been issued by the sovereign and is held by the private sector.

In looking at the tactical considerations thrown up by the SDRM, certain further arbitrage possibilities for sovereigns and their investors become clear. These arbitrage opportunities will work to further restrict the usefulness of the SDRM. It is entirely possible for a sovereign seeking new finance to arrange for one of its entities – the central bank or some export credit entity, for example, – to issue debt. *Pari passu* treatment with sovereign creditors can be provided through a sovereign guarantee. Such debt would escape being caught by a potential SDRM stay. It might therefore be viewed by investors as being more attractive that debt issued directly by the sovereign, particularly if the borrowing entity had significant assets and capital. There is already much debt of such entities in the marketplace. The introduction of the SDRM is likely to give sovereigns an incentive to use such yield-enhancing structures. The amount of such paper will probably rise. Such a development would parallel the growth in bankruptcy remote

securitization vehicles in the private sector markets of advanced countries. Such developments would simply reduce the utility of the SDRM in country restructurings.

In theory, these various problems caused by indebtedness that falls outside of the ambit of the SDRM can be solved by extending the reach of the SDRM. Because of the seriousness of the problems outlined above, some commentators have recommended such a broadening of the reach of the SDRM. To solve these problems through extensions to the reach of the SDRM would require the implementation of mechanisms to handle issues such as solvency criteria for admission to the stay, consolidation of related entities for inclusion under the stay, adequate protection, judgements about relative seniority, preference payment rules, formation of classes for voting purposes, and the like. In other words, the SDRM would in effect require a full bankruptcy code as well as a court to exercise judgement in such cases. [18]

Since much of the foreign held debt issued by a sovereign and its public and private sector entities is subject to the jurisdiction of the country's own courts, in theory the reach of the new SDRM bankruptcy code should be extended to cover domestic entities that fall under domestic law. The practical result of such an extension would be that any compromise reached under such an international court would remain subject to rejection by the sovereign. Such a move would simply add to the unpredictability of any compromise that might be reached under the SDRM.

In summary, once one starts down the path of broadening the SDRM towards a full bankruptcy code and court, it is extremely difficult to stop since any partial steps along the path themselves raise problems that can only be solved by progressing further down the path. Any broadening rapidly runs into a very steep curve of complexity and unpredictability. This is a fundamental dilemma that architects of a SDRM cannot escape.

Once the complexities inherent in any broadening of the SDRM concept are understood, the point at which the IMF's proposed mechanism cuts off is seen to be well judged. It allows only for the imposition of a stay, the provision of priority loans and the utilization of a defined voting mechanism. [19] It goes no further and avoids the complex problems inherent in a broader

SDRM that only lead to decreases in both its ease of use and its predictability of outcome. There is therefore a strong underlying rationale for the limitations to the mechanism designed by the IMF.

Supporting these structural reasons for limiting the ambit of the proposal are the problems inherent in any infringement of sovereign power required for any broadening of the proposed SDRM. Any such threats to sovereignty are likely to impair the political support required among the majority of IMF member countries for the adoption of a broadened SDRM.

As a result, the structure leaves open serious questions about the number of crises in which the SDRM could play a useful role in avoiding the need for a broad debt moratorium and exchange controls. It is so open to arbitrage and defeasement by issuers that its actual scope for improving the international financial architecture is probably very limited. Its use for crisis prevention is likely to be restricted to those smaller countries where the foreign debt is issued mostly by the sovereign and where the country's liability sheet is uncomplicated. For countries with complex liability structures or with significant amounts of debt not directly issued by the sovereign, the SDRM is likely to prove to be of any use in crisis prevention.

In summary, this analysis suggests that the SDRM may fail to achieve any of the objectives claimed by the IMF. It is likely to decrease the predictability of all but a few of the smaller sovereign debt crises. The claimed 'value preserving' characteristics may in fact turn out to be value-destroying characteristics. The implementation of the mechanism may in fact induce crises in cases where short-term lenders would otherwise have retained their exposures. Any conclusion that the mechanism would serve to reduce the number of cases where the IMF were pressured into risky lender of last resort credits is speculative at best. And finally, the mechanism seems quite likely to increase the cost of debt and to reduce its availability for emerging market issuers.

8. Is SDRM Reversible?

The SDRM, it is argued, can be reversed without inducing any costs. Official sector spokesmen have used this argument to turn aside private sector objections to the SDRM by saying that its benefits can be gained without incurring any downside risks.

The validity of this argument should be tested on two levels: first, whether a sovereign tht invokes the SDRM can reverse its action at no cost; and second, whether the IMF could reverse itself in implementing the SDRM once it announces its intention to put the mechanism into place.

First, take the case of a stretched sovereign that invokes and SDRM stay. For three months the sovereign will hold its private creditors at bay. During this period, considerable changes can be wrought in the affairs of the sovereign, including the repayment of debt that is not subject to the SDRM stay. While the SDRM-stayed creditors would raise strong objections to such developments, they would have no ability to impede them. [20] This dissatisfaction may very well result in the stayed creditors voting to bring the SDRM stay to an early end.

Even when the sovereign treats all its creditors in a transparent and fair fashion, there are likely to be cases where the requisite majority of creditors is unwilling to extend the stay beyond the initial 90 days. If creditors are led to feel that the SDRM stay has been used merely as a delaying tactic and that the sovereign is unwilling to dedicate a sufficiently high portion of its potential net resources to debt repayment, then an affirmative vote to extend would not be forthcoming. In other words, these negotiations during the stay will take place in the shadow of a full-blown debt crisis outside the protection of the SDRM.

For a sovereign that gives signals that it is intending to use the SDRM to significantly improve the compromise that would otherwise be available from private investors, there is a real likelihood that an extension of the stay will be voted down at the end of 90 days. The danger lies in the gap in expectations between the sovereign and its investors. And if the stay is voted down, the sovereign will have a demonstrated record of inadequate cooperation with investors. The climate for the next round of negotiations will have been damaged.

One result of the increased friction between the sovereign and its creditors will be further shifts in the composition of the group of debt holders. Prices for the bonds are likely to drop further. More hard-line, litigious investors will take positions in the debt. Such shifts are likely to render negotiations more difficult. In such circumstances, the SDRM stay is simply not "reversible". The sovereign will be in a worse position going into a new round of negotiations than if it had not started out by trying to use the SDRM.

What about reversibility of the IMF's proposal for implementing an SDRM in the first place? Once the IMF has announced a decision in principle to proceed with the mechanism, will it be able to abandon the initiative if it concludes that the potential benefits appear too meagre and the costs to high?

There is good reason to believe that once a concrete proposal for an SDRM is tabled, it will become increasingly difficult for the G7 and the IMF to shelve the proposal. The high-level logic in its favour is extremely appealing. The pitfalls of the mechanism arise from the operation of its details, not from its fundamental purposes. The law of unintended consequences has rarely been appreciated in the public debates about financial structure. An increasing number of NGO's and 'civil society' groups have been attracted to the mechanism because of their instinctive feeling about the fairness that will be provided by the mechanism, and because of their feeling that less developed countries will benefit. Few people beyond active market participants have any sense of the adverse consequences that will flow from the incentives that are set up, and so the costs of the proposal will be largely overlooked in the debate.

Further, once it appears likely that some form of the SDRM will be implemented, both issuers and investors will begin the type of portfolio restructuring that has been described above. Such movements are probably irreversible.

Finally, the movement by the private sector to develop and implement broader Collective Action Clauses in debt instruments – work that is also aimed at improving the functioning and predictability of sovereign restructuring – will likely come to an end. Investors see the SDRM as reducing their bargaining power in sovereign restructuring. The climate will become hostile for

further voluntary moves that diminish investor influence through the introduction of collective action clauses. Moreover, with the prospect of an overriding regime, investors cannot be certain what changes can be safely made to bond indentures without know which form the new regime will take.

At the same time, recognizing that crises may be triggered at an earlier stage in a sovereign's financial deterioration, investors may well start reaching for financial performance clauses that would improve their ability to bring the sovereign to the table at an earlier stage, and so to provide some protection to bondholders against the moves by other shorter term creditors to protect their positions. Such moves, once begun, are likely to prove irreversible.

In summary, at some point in the official discussion about SDRM, the expectations among various parties will be raised to the point where shelving the proposal will become very costly for the official sector. At that point, the IMF will probably find that it cannot back away from instituting some form of SDRM.

9. Next Steps.

The G7 have indicated that they wish to see a concrete proposal for the SDRM by the Spring of 2003. [21] There is therefore little time left before the official sector commitment to the SDRM may become firm.

As this paper has argued, the costs of the SDRM lie largely in the operation of the law of unintended consequences. They arise from the reaction of market participants to the risks and incentives set up by the SDRM. They also arise from the interaction of the features of the debt covered by the SDRM and the features of foreign debt that is not covered. And most fundamentally, they arise from the essentially sovereign nature of independent states.

Much of the analysis over the past year has proceeded by metaphor, largely by drawing parallels with the structure of *Chapter 11* and sometimes *Chapter 9*. Yet the international

financial architecture is far too important a subject for us to analyse purely through analogy. Much more concrete analysis needs to be done on the incentives and the likely patterns that will be induced by the SDRM.

The analysis should proceed by taking a series of actual crises and near-crises over the past ten or fifteen years and inquiring how each of these crises might have played out had an SDRM facility been in place as the sovereign's condition deteriorated. The analysis should look at how the players – issuers, investors and short term banks and other institutions – would have shifted their behaviour in anticipation of the use of the SDRM by the sovereign.

Those undertaking the analysis should take into account the actual outcomes of these crises and near crises, and estimate the extent to which the SDRM might have improved or worsened the actual outcome for the various players. It should look at the resulting levels of equity in the system.

Those undertaking the analysis should consider their comfort with the conclusions about the ranges of possible outcomes. A high degree of uncertainty would have to translate into a conclusion that the impact of the SDRM is extremely difficult to predict – and hence its introduction would entail significant risks.

Objections may be made that such analysis produces results that are conjectural and clouded by hindsight. These same objections, however, apply with equal force to the analysis by the IMF of the benefits offered by the proposed SDRM. The official sector's analysis of the benefits is based on an unspoken assumption that there will be no material reactions within the private sector to defease or arbitrage the risks posed by the SDRM. Such an assumption is aggressive and requires defence. They only way to provide such a defence is to analyse the possible reactions of private sector players to potential and actual crises in an attempt to demonstrate either that there are few options to defease or arbitrage the SDRM, or that the reaction by private sector players to these options will be immaterial. Such an analysis, by its nature, is unavoidably conjectural. This conclusion underlines the speculative nature of the official sector's assertion that the SDRM will provide net benefits in the handling of future

international crises. As this paper suggests, the attempt to defend an assumption of immaterial private sector reactions is likely to prove ineffective.

So if we are to avoid the introduction of a major new piece of international financial architecture on the basis of purely theoretical conjecture we must undertake a reasoned inquiry into the likely effects the mechanism might have on the actual operation of international financial markets in crisis.

The analysis of the likely impact on incentives and behaviour following the introduction of the SDRM should be undertaken by the official sector in partnership with representatives of the private sector. The private sector will be much more aware of the risks and incentives that will be set up under the SDRM, and the range of potential reactions to these risks and incentives. As a result, the conclusions will be more robust.

Moreover, public sector officials need to convince the private sector participants that their belief in the existence of risk adjusted net benefits to the SDRM is reasonable. This can be done only through concrete analysis of how the SDRM is likely to work in practice. Failure to convince the private sector of these benefits will lead to the self-fulfilling prophecy under which investors, fearful of increased losses, reduce their commitments to emerging market borrowers and raise costs for new issues – whatever the benefits from the SDRM perceived by the official sector.

At the same time public and private sector players should examine the potential for new Collective Action Clauses to improve the workability of sovereign restructurings. While the private sector has been advocating CAC's, the analysis of the extent to which such clauses could actually improve crisis resolution has been thin. Further work needs to be done on mechanisms for allowing the voting process on separate *pari passu* bond indentures to be amalgamated as a means of controlling rogue creditor problems. And work needs to be done to examine how the existing stock of debt could be brought more quickly into such a CAC framework than waiting for the evolution of maturities.

Given the short time frames under which G7 and the IMF are working, it is essential that this work be commenced on an expedited basis.

10. Conclusion

In the view of he IMF, the SDRM offers considerable benefits to the international community. It is seen as increasing the predictability of a restructuring negotiation and as improving the IMF's ability to turn aside a request for funding since the restructuring mechanism would provide a workable alternative.

The private sector has responded with a very different view. While the mechanism may possibly prove to be of use to a few smaller countries where restructuring of the sovereign's private debt alone will solve the problem, the mechanism will be of little use for countries where the liability structure is complex. The result of the introduction of the SDRM, in this view, will be an increase in the levels of losses to investors in emerging market debt, a decrease in the predictability of outcomes for such countries, and a decrease in the levels of equity in the system.

These two views badly need reconciliation. If the private sector views are shown to have validity, the risk adjusted net benefits estimated for the mechanism are negligible at best, and probably negative. With such a conclusion, the proposal for SDRM should be quietly shelved.

Moreover, if the public sector is not able to convince important private sector players that their views are wrong, these players will react on the basis of their own view. The result is that the mere announcement of the introduction of the SDRM will cause an increase in the cost of capital for emerging market borrowers. Such a probable result should be grounds for setting the SDRM aside. The potential costs are simply too high.

Given the short time frames self-imposed by the IMF and the G7, it is essential that the public and private sectors begin a hard analysis of the range of potential impacts of the potential impacts of the proposed mechanism, and that they build a much clearly view of the likely

changes to the levels of efficiency, equity and predictability that will result from the introduction of the SDRM. If the analysis of this paper is guide to the result of this analysis, the IMF's SDRM proposal will have to be quietly shelved.

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[1] Anne O. Krueger, *A New Approach to Sovereign Debt Restructuring*, International Monetary Fund, April, 2002

[2] See, "IMF Board Discusses Possible Features of a New Sovereign Debt Restructuring Mechanism", Public Information Notice, 02/106, September 24th, 2002.

[3] See "Statement of G-7 Finance Ministers and Central Bank Governors", Department of Finance, Canada, Washington D.C., September 27th, 2002. See also "IMF Board Discusses Possible Features of a new Sovereign Debt Restructuring Mechanism:, IMF, Public Information Notice 02/106, September 24th, 2002.

[4] See "Involving the Private Sector in the Resolution of Financial Crises – Restructuring International Sovereign Bonds" Prepared by the Policy Development and Review and Legal Departments, International Monetary Fund, January, 2001.

[5] See "Action Plan of the IIF Special Committee on Crisis Prevention and Resolution in Emerging Markets", Institute of International Finance, Washington, 2002

[6] See Krueger, April, 2002, *op. cit.,* page 4. There is, however, no unambiguous and measurable definition of the point of unsustainability. See also "IMF Discusses Assessments of Sustainability", Public Information Notice No. 2/69, July 11th, 2002. See also Anne O. Krueger, "Crisis Prevention and Resolution: The Role of the Sovereign Debt Restructuring", Remarks at the American Enterprise Institute Symposium, Washington, revised, October, 17th, 2002. Page 4 of this document notes that "… there has to be a consistency between the Fund's judgements about the sustainable economic program and the feasible size of primary surpluses, on the one hand, and the size of the "haircut" agreed to by the creditors and the debtors on the other." It would seem that the Fund intends to determine the extent of 'sustainability", not the debtor and its creditors through free negotiation. See "IMF Board Discusses the Good-Faith criterion under the Fund Policy on Lending into Arrears to Private Creditors", Public Information Notice No. 02/107, IMF, Washington, September 24th, 2002. Fund Directors noted (page 5) "… that to the extent that negotiations become stalled because creditors are requesting terms that are inconsistent with the adjustment and financing parameters that have been established under a Fund-supported program, the Fund should retain the flexibility to continue to support members notwithstanding the lack of progress in negotiations with creditors. In this connection, it was stressed that decision on an adequate macro-economic framework that could form the basis for the Fund's lending into arrears will remain in the sole purview of the Fund. … it would be inappropriate for private creditors to be given a veto over the design of the financing plan or the design of the adjustment program."

[7] Debtor-in-possession financing under *Chapter 11* is effectively constrained to the amounts needed by the corporation to continue to operate in a manner that preserves value. It is difficult ot conceive of a similar constraining principle that could be applied in a reliable way to a sovereign. See Krueger, April 2002, *op. cit*., page 17. "It is in the collective interest of private creditors and the sovereign debtor that new money be provided in appropriate amounts". A description of how appropriate levels would be determined is not sketched out. A considerable degree of judgement would have to be exercised by the IMF or the SDRM 'court' in deciding the amounts of such financing that could be made available to the sovereign under the stay. While *ibid*. page 28, talks about giving "… a qualified majority of private creditors the power to subordinate the claims of all private creditors to the claims arising from the financing provided after the effectiveness of the stay," it is not clear whether this qualified majority would also control the amounts of priority funding that would be provided. For good reason, the private sectors are fearful that there could be significant abuses.

[8] See Krueger, April 2002, *op. cit*., page 17, which notes that "… new money could help cover the sovereign's need for trade credit…."

[9] See Allan Beattie and Peronet Despeignes, "IMF fights for new sovereign debt rules", *Financial Times*, September 30th, 2002.

[10] There is some ambiguity in the IMF papers about the options open to the sovereign that wishes to trigger a filing under the SDRM. See Krueger, April 2002, *op. cit*., page 26, which suggests that one design option for the SDRM would see the sovereign petitioning for a stay that would not come into effect unless a qualified percentage of creditors votes in favour of the stay. Recognition is given to the practical need to keep the period for the vote short, and to the possible need for the imposition of capital controls to protect against a flight of capital during the period until the vote takes place. How such a mechanism would work in practice, however, is difficult to understand. As soon as the sovereign submits its request for a stay, lenders and investors will do everything possible to trim their positions. The capital controls suggested by Krueger are a form of moratorium. To provide equitable treatment with other creditors and to prevent the collapse of the markets for other short term obligations not stayed by capital controls, a broad moratorium would also probably have to be imposed at the same time as the request for the stay is filed. In such circumstances, the role of the stay under the SDRM becomes somewhat vestigial.

The IMF seems to have recognized this difficulty. "Sovereign Debt Restructuring Mechanism – Further Considerations", IMF, Washington, August 14th, 2002, paragraph 10, page 6 states unambiguously that "The Sovereign debtors would have the exclusive authority to decide whether and when to activate the SDRM."

[11] The IMF suggests that priority financing by private institutions should be available once a qualified majority of creditors vote in favour of such financing. See Krueger, April, 2002, *op. cit*., page 17. The requirement for a majority vote complicates the use of the mechanism. *Ex ante*, the sovereign would have difficulty in assessing the likelihood of achieving a favourable vote. The sovereign could not canvass creditors in advance since posing such a question would simply alert them to the likelihood of a filing and provoke the uncontrolled crisis that the sovereign wishes to avoid. A requirement for a majority vote on priority loans adds significantly to the unpredictability in the use of the SDRM. It complicates the calculations of both the borrower and the creditors on the choices of both strategy and timing.

There is, however, an alternative route to priority funding that should be noted. The IMF has adopted a policy of lending into arrears. See "The IMF Board Discusses the Good-Faith Criterion under the Fund Policy on Lending into Arrears to Private Creditors," Public Information Notice No. 02/107, September 24th, 2002. See also "Fund Policy on Lending into Arrears to Private Creditors – Further Consideration of the Good Faith Criterion", IMF, Washington, July 30th, 2002. The IMF will entertain loans to the sovereign where prompt Fund support is considered essential for the member's adjustment program and where the member is pursuing appropriate policies and is making a good faith effort to reach a collaborative agreement with its creditors. This policy is explicitly seen as a complement to the SDRM (see *ibid*, paragraph 3, page 2.) It seems clear that the availability of such IMF funding could bridge the period between the announcement of a stay under the SDRM and a vote by creditors on the provision of priority funding from the private sector.

This availability of fresh loans that will be senior to existing indebtedness is a key element in the attractiveness of SDRM for financially strained sovereigns. Without this feature, the SDRM, as currently conceived, provides little more than a stay plus a legislated version of collective action clauses. When the SDRM is looked at in this light, a possible compromise opens up between the official and private sector positions. Since the principles that could limit debtor-in-possession loans to sovereigns under a stay are so unclear and as abuses are so likely, the potential for such loans should be removed from the SDRM proposal. The proposal then becomes a mechanism through which a minimum standard for CACs can be designed and implemented on a legislated basis. Many indentures contain language that constrains acceleration of debt (and therefore recourse to the court) to situations where the sovereign has defaulted and a minimum percentage – often 25% - of bond holders have voted to declare the default and accelerate the debt. In other words, such collective action clauses already contain automatic provisions for a stay. Such a covenant pattern could be the model for voting procedures for a modified SDRM.

[12] This is, of course, the problem that CAC's are designed to solve.

[13] See Krueger, April 2002, *op. cit*., page 5 and pages 35-37 which argues the advantages of the earlier filing.

Taken together, these various features of the SDRM should lower the expected cost of a debt restructuring for a sovereign. This in turn will have an impact on the estimated level of sustainable debt for a country. The IMF, in its paper "Assessing Sustainability" of May, 2002, page 20, lays out "Good Practices for Realistic Sustainability Assessments". The third principle maintains that "The sustainability assessment should be based on the fiscal measures needed to achieve the projected debt path." The tax and expenditure measures underlying the assessments need to be specified, along with a judgement as to "… whether these measures are sustainable over time, both technically and politically." A drop in the cost (price) of a restructuring brought about by the introduction of the SDRM will reduce the size of the politically feasible surplus by making a restructuring more politically acceptable. Put differently, the introduction of the SDRM is likely to reduce the measure of sustainable debt generated using the IMF's own analytical process for evaluating sustainability.

[14] The SDRM does not cover private trade debt or short term debt of private financial institutions and companies. A fear that the sovereign may be approaching a default will increase the risks inherent in credit extended by foreign lenders to domestic institutions. This will lead to a curtailment of such exposures. As the overall levels of such cross-border funding of the country's private sector are reduced, ultimate settlement will be provided through draw-downs on the sovereign's foreign currency reserves. This will further increase the risks faced by the sovereign and its creditors. As a result, while trade credit and other short term private accommodation is formally excluded from the ambit of the SDRM stay, the potential for the sovereign filing under the SDRM at an earlier stage than it would have in the absence of the SDRM will inevitably affect risk perceptions of international banks and other private institutions providing short term accommodation to companies in the sovereign's private sector. The fear of an earlier filing under the SDRM and the imposition of foreign exchange controls will therefore lead to an earlier run-down in trade credit and other short-term accommodation. In short, the introduction of the SDRM will simply accelerate the point at which a crisis is triggered.

See also Nouriel Roubini, "Private Sector Involvement in Crisis Resolution and Mechanisms for Dealing with Sovereign Debt Problems" prepared for the Bank of England Conference on the Role of the Official and Private Sector in Resolving International Financial Crises, London, July 23rd-24th, 2002.

[15] See Krueger, April 2002, *op cit*., pages 18 and 19, which recognize that the degree of impairment of the sovereign's debt held by domestic institutions may have to be less than the degree of impairment of foreign holders of *pari passu* debt to ensure that the solvency of these domestic institutions is protected. Without such protection, the ability of the country to generate debt service will be impaired.

[16] Krueger, April 2002, *op. cit*., page 28, notes that the risk of a rejection of a proposal by creditors could be reduced "… by the resolute application of the IMF's policy of lending into arrears, under which it signals its willingness to continue to support a program, even if the member has interrupted its payments to its creditors." On its face, this suggestion seems to offer a lender of last resort facility of indeterminate size to debtor sovereigns. This generates a clear risk of significant moral hazard for debtor nations. This suggestion also tends to reduce the influence of creditors in negotiating a restructuring, and to add another layer of unquantifiable risk to sovereign lending.

It is clear that the official sector has structured its SDRM proposal to provide itself with very significant influence over any outcome to a potential crisis. Wishing to conserve scarce official resources, the IMF may direct financially stretched countries to avail themselves of the SDRM mechanism. The IMF will determine the appropriate level of "sustainable" debt – the key determinant of the amount of compromise that will have to be made by private sector lenders (see footnote 6 above), the IMF will determine the amounts of priority funding it will provide the sovereign (see also footnotes 7, 8 and 11 above), and an IMF entity will have a say on the composition of classes for voting purposes – a key determinant of the likelihood of a successful compromise (see footnote 19 below.) The IMF will be the entity that decides whether or not the sovereign continues to meet the tests for

protection under the SDRM, including the obligations not to repay non-priority creditors and to act in a fashion that protects asset values (see footnote 20 below.) Finally, in a completely different set of negotiations with the sovereign, the official sector will determine the amount of compromise (if any) that will be taken on the debt to the official sector (see footnote 17 below.) There is a belief amount some private sector players that the influence of private debt holders will be very significantly eroded through the introduction of the SDRM – further added to concerns about the likely volatility and loss levels of emerging market debt under an SDRM regime.

[17] The decision of the IMF to leave debt owing to the official sector of the SDRM has heightened the hostility of the private sector to the proposed SDRM. There is no persuasive logic to leaving the official sector debt outside of the negotiation processes. In many cases, the test of sustainability will only be possible once the degree of compromise of both the private sector and the official sector debt has been achieved. Private sector investors fear that the omission of the official sector debt from the SDRM will simply result in the mechanism working to ensure that the official sector achieves a higher recovery rate than is achieved by private investors – even though most debt of sovereign to foreign government entities ranks *pari passu* with their obligations to the private sector.

[18] When the SDRM is broadened to cover a range of entities within a country that have foreign obligations, the analogy with *Chapter 11* loses much of its meaning.

Chapter 11 applies to the individual company that has become insolvent. Its objective is to stabilize the debtor for the benefit of all creditors, and to organize the distribution of value taking account of the set of relationships set up by contract between the debtor and its creditors. Relationships set up by contract between the debtor and its creditors. Relationships between creditors are governed by their relative rankings set up by contract with the debtor before filing. Rankings are determined by whether the obligations are senior or subordinate, secured or unsecured, or whether they arise from some other type of structure such as a lease. Behind the structure of *Chapter 11* and its practice in the courts, there is a very cogently reasoned body of thought on the equities of various types of parties to the insolvency. See, for example, Thomas Jackson, *The Logic and Limits of Bankruptcy*, Harvard U.P., 1986.

In contrast, the SDRM applies to a range of entities, many of which may individually be perfectly solvent. Their problem arises, however, from the inability of the country as a whole to generate sufficient foreign exchange for the cross-border obligations to be retired in a timely fashion. The fundamental problem addressed by the SDRM is the overarching problem of the country's excessive indebtedness, not that of the individual government or non-government entity. Further, the degree of 'over-indebtedness' is not determined by the "net asset values" of the entities in the proceeding, it is determined by a rather vague concept of 'sustainability'. Finally, under the IMF's proposals, the determination of 'sustainable debt' will be made by the IMF and not by the free negotiation between creditors and the debtor (see Footnote 6, above.)

Under a broadened SDRM, the ambit of the stay would be extended to include a variety of government entities with foreign indebtedness, including the central bank and other government agencies. It would also be extended to cover private sector entities with private debt. Rules would have to be designed to provide criteria for admission to coverage under the stay, otherwise there would be very broad opportunities for the sovereign to cherry-pick which entities should be included and which should be left out of the proceedings. These choices of coverage could have large effects on the recoveries for creditors. Creditors would have to have rights of appeal to the SDRM bankruptcy court. There would also have to be rules regarding consolidation of entities, for the relative ranking of debt, for the sharing of assets, and for the purposes of forming classes and of voting. Given the likely heterogeneity of potential entities in the proceeding and the lack of any indentures or loan agreements spanning these entities that provide a set of relative rankings of debt across these entities, there is great uncertainty as to how such rules could be drafted. However, drafted, these new rules would almost certainly add considerably to the unpredictability of outcomes under the SDRM. Undoubtedly, large discretion would have to be left to the SDRM court to ensure some modicum of equity in the proceedings. Again, creditors would have to have rights of appeal.

Complicating the writing of the SDRM Code and the development of practice under the Code is the absence of any theory of equities comparable to that of *Chapter 11* that could be used to guide the drafters and the judges.

The allowable time limits for the stay would have to be substantially lengthened to accommodate all pleadings under these rules. The whole process under a broader SDRM would threaten to take very considerably longer to achieve a result than under today's exchange offers. In short, a broader SDRM could end up providing the antithesis of a market-based restructuring mechanism that allows a rapid restoration of the country's access to international capital markets.

[19] The SDRM is left with one complexity that will prove troubling. The IMF has recognized that the sovereign may have groups of creditors who hold obligations of differing characteristics. See "IMF Board Discusses Possible Features of a New Sovereign Debt Restructuring Mechanism", IMF, Washington, Public Information Notice 02/106, September 24th, 2002, page 3. "Accordingly, Directors indicated that the establishment of a classification system whereby claims are aggregated within – but not across – classes for voting purposes would be appropriate." While equity considerations may call for such a system in the case of many sovereign liability structures, the introduction of such a system will require rules for the segregation of claims by class, and will require some form of court to exercise judgement in classifying creditors in the case of actual filings. Experience with *Chapter 11* indicates that there will be significant scope for disputes as individual creditors seek to maximize their bargaining influence by seeking to sub-divide creditor classes. In short, once this principle of classes is recognized, the SDRM runs into problems of aggregation of the kind faced by Collective Action Clauses. See also Anne Krueger, "Crisis Prevention and Resolution: The Role of Sovereign Debt Restructuring", IMF, Washington, revised, October 17th, 2002, page 3.

[20] See Krueger, April 2002, *op. cit*., page 16. The constraints on the sovereign requires that it "… not make payments to non-priority creditors" and that there may be "… assurances that the debtor would conduct policies in a fashion that preserves asset values." The "asset values" that will be used in the application of this test are nowhere spelled out. Presumably these constraints refer only to the sovereign itself. The constrains do not appear to apply to agencies or entities owned by the sovereign, nor do they apply to the broad range of private sector entities that have external obligations the repayment of which will result in a loss of the sovereign's foreign exchange reserves. Presumably the IMF will be the judge of whether the sovereign respects the constraints. Not surprisingly, some scepticism has been expressed by private sector observers about the likely strength of these constraints in practice.

[21] See "Statement of the G-7 Finance Ministers and Central Bank Governors", September 27th, 2002, *op. cit.*