DISCUSSION PAPER SERIES

No. 4717

RESOLUTION OF SOVEREIGN DEBT CRISES: THE NEW OLD FRAMEWORK

Richard Portes

INTERNATIONAL MACROECONOMICS

Centre for Economic Policy Research

www.cepr.org

Available online at: **www.cepr.org/pubs/dps/DP4717.asp**

ISSN 0265-8003

RESOLUTION OF SOVEREIGN DEBT CRISES: THE NEW OLD FRAMEWORK

Richard Portes, London Business School (LBS) and CEPR

Discussion Paper No. 4717
October 2004

Centre for Economic Policy Research
90–98 Goswell Rd, London EC1V 7RR, UK
Tel: (44 20) 7878 2900, Fax: (44 20) 7878 2999
Email: cepr@cepr.org, Website: www.cepr.org

This Discussion Paper is issued under the auspices of the Centre's research programme in **INTERNATIONAL MACROECONOMICS**. Any opinions expressed here are those of the author(s) and not those of the Centre for Economic Policy Research. Research disseminated by CEPR may include views on policy, but the Centre itself takes no institutional policy positions.

The Centre for Economic Policy Research was established in 1983 as a private educational charity, to promote independent analysis and public discussion of open economies and the relations among them. It is pluralist and non-partisan, bringing economic research to bear on the analysis of medium- and long-run policy questions. Institutional (core) finance for the Centre has been provided through major grants from the Economic and Social Research Council, under which an ESRC Resource Centre operates within CEPR; the Esmée Fairbairn Charitable Trust; and the Bank of England. These organizations do not give prior review to the Centre's publications, nor do they necessarily endorse the views expressed therein.

These Discussion Papers often represent preliminary or incomplete work, circulated to encourage discussion and comment. Citation and use of such a paper should take account of its provisional character.

Copyright: Richard Portes

CEPR Discussion Paper No. 4717

October 2004

ABSTRACT

Resolution of Sovereign Debt Crises: The New Old Framework*

The paper sets out the principles that should underlie sovereign debt restructuring. It argues for a rules-based approach to achieve private sector involvement in restructuring. The rules must operate, however, in the context of an appropriate institutional framework with appropriate incentives. The markets cannot and will not create these institutions without some official intervention. The Paper discusses why intervention in the form of a Sovereign Debt Restructuring Mechanism has been shelved. It goes on to consider a new institutional framework, with a permanent bondholders' committee and collective action clauses (CACs) in bond contracts. It stresses the need for uniformity in CACs. After interpreting the views of market participants on CACs, the Paper concludes with an argument for official intervention to make CACs universal.

JEL Classification: F33 and F34
Keywords: collective action clauses, financial crises, sovereign debt

Richard Portes
London Business School
Sussex Place
London
NW1 4SA
Tel: (44 20) 7706 6886
Fax: (44 20) 7402 0718
Email: rportes@london.edu

For further Discussion Papers by this author see:
www.cepr.org/pubs/new-dps/dplist.asp?authorid=147836

*This paper is a revised version of a presentation to the ABCDE-E conference organized by the World Bank and held at the French Ministry of Finance in May 2003. It draws on joint work with Daniel Cohen in a report prepared for the Conseil d'Analyse Economique, *Crise souveraine: entre prévention et resolution*, CAE Rapport no. 43, September 2003, Documentation Française. I have benefited from comments by two anonymous referees. The paper will appear in *Economic Integration and Social Responsibility*, Proceedings of the 2003 ABCDE Europe Conference, ed. François Bourguignon and Pierre Jacquet, Oxford University Press, 2005.

Submitted 06 October 2004

Resolution of Sovereign Debt Crises: The New Old Framework

Richard Portes
(London Business School, EHESS and CEPR)

October 2004

1. Introduction

International finance carries inherent risks of instability and financial crisis – just as many individual firms may experience financial distress. Eliminating risk would eliminate the high returns that often come from taking risks. Investors, whether firms or countries, therefore accept the risks, and institutions develop to mitigate the costs when some risks do go bad. But those institutions are still weak at the international level.

The widespread debt crisis of the 1980s became 'the lost decade' for Latin America, and the banks ultimately had to accept substantial write-offs. The Asian crisis of 1997-98 was devastating at the time and is still not over for Indonesia. The Russian default of August 1998 was settled relatively quickly, but even quicker were the shock waves it sent out to the financial markets – with some role in the failure of LTCM, a sharp rise of all emerging market bond spreads, and the subsequent Brazilian exchange-rate crisis. Dealing with country debt crises is always very messy, often protracted and very costly to both debtor and creditors.

Orderly resolution of sovereign debt crises has in fact become more difficult in the past decade. The shift from the syndicated bank loans of the 1970s to a mix of short-term bank finance and bonds has created a much wider group of creditors and instruments. This exacerbates the 'rush to the exits' by creditors in a crisis and the collective action problems involved in debt restructuring. What seems rational for an individual creditor trying to get his money out becomes counterproductive when all try to do so simultaneously, or when they cannot agree to accept some loss if some think they can do better acting alone.

The debtor knows that restructuring will be difficult in these circumstances and therefore may do everything possible to delay the inevitable, often as a result making it worse when it does come. Then, once a restructuring is finally agreed by most creditors, holdout ('rogue') creditors can seek to extract full payment – so all creditors are concerned ex ante about such free-rider behaviour, and that itself impedes agreement. During a protracted restructuring, the debtor faces severe financing problems – it may be impossible to get 'new money', often including trade credit. The abrupt compression of imports and shift into exports can be a very

painful adjustment, often accompanied by deep falls in output. The absence of a framework for orderly workouts increases the pressure on the IMF and G7 to step in with bailout packages, because a disorderly workout appears too unpalatable.

There are alternatives. There were discussions of an institutional framework for sovereign debt workouts in the 1980s – ranging from proposals for an international bankruptcy court to using debt buybacks in a market-based mechanism. Eichengreen and Portes (1988, 1989) drew some lessons from historical experience with the Council of Foreign Bondholders (CFB) and the Foreign Bondholders Protective Committee (FBPC). The 1980s debt crisis was ultimately resolved through the Brady Plan, backed by pressure from the IMF through offers of lending into arrears (LIA).

After the Mexican crisis of 1994-95, Jeffrey Sachs (1995) proposed an international bankruptcy regime modelled on Chapter 11 of the US bankruptcy code. Eichengreen and Portes (1995) argued instead for a combination of contractual and institutional changes that would not require an international bankruptcy court. In particular, they stressed the benefits of collective action clauses (CACs). The G10 deputies issued a report in May 1996 that advocated the latter route (G10, 1996). Rogoff and Zettelmeyer (2003) provide a detailed study of the literature on institutional frameworks for sovereign borrowing and workouts. Despite this extensive discussion, nothing was done, because the G10 left any action to the initiative of market participants. But the lenders had already expressed their opposition to any measures that would, as they put it, 'make default easier' (IIF, 1996). It should instead be as 'painful and messy' as possible, they said, in order to deter any violation of the sanctity of contracts.

The discussions on the international financial architecture that followed the Asian crisis of 1997-98 revived the debate, which was stimulated further by the Russian default of August 1998, with its impact on Brazil. But both the conclusions and the results were the same as before: no change. The crises in Turkey and Argentina were handled in much the same way as the Asian crises – a pre-crisis period of exchange-rate rigidity, endorsed by the IMF, followed by big bailout packages when trouble came. Only the debacle and default of Argentina broke the pattern, and the consequences were disastrous for that country, if not for the international financial system.

Then a major initiative emerged from the IMF. In November 2001, Anne Krueger, First Deputy Managing Director, advocated a Sovereign Debt Restructuring Mechanism (SDRM)

to facilitate a declaration of insolvency for an over-indebted country along the lines of Chapter 11 of the US Bankruptcy Code. Setting out a considered proposal four months after her first declaration, she responded to criticism by reducing significantly the implementing role of the IMF; but the SDRM would still require an international treaty or amendment of the IMF Articles of Agreement (Krueger, 2002). John Taylor, US Undersecretary of the Treasury for International Affairs, responded immediately with an extended version of the proposals for contractual changes that had appeared in 1995-96 (Taylor, 2002), explicitly withholding endorsement of any international bankruptcy procedures. The G7 then adopted the US position, while saying that the IMF should continue work to refine its plan. At the autumn 2002 IMF annual meetings, the 'two-track' approach was confirmed: further work on the SDRM, to be presented at the April 2003 IMF meetings, side-by-side with efforts to make actual progress on Collective Action Clauses (CACs). In April 2003, however, the SDRM proposal was shelved *sine die* (IMF, 2003). Nevertheless, the Krueger initiative unblocked discussion and has led to some innovation, as we discuss below. And meanwhile there has been some progress with CACs.

It might be argued that a truly new international financial architecture requires full recognition that international financial stability is a public good which will be supplied only with true collective action. The necessary institutions would be not just an SDRM to deal with *ex-post* resolution of debt (solvency) crises, but also an international lender of last resort (ILLR) to ensure that liquidity crises are not contagious and do not become solvency crises. Stanley Fischer, the previous First Deputy Managing Director of the IMF, had proposed this role for the Fund (Fischer, 1999). But his proposal too has not led to any action.

We shall not consider further here the desirability and feasibility of making the Fund into an ILLR (although we have shown elsewhere why and how it should become a lender of *first* resort: Cohen and Portes, 2004a, 2004b). We argue below that negotiation between debtors and creditors in *an appropriate contractual and institutional framework* would go a long way at least towards filling the gap that motivated the SDRM proposals.

2. General principles

Comparisons between sovereign and corporate debts usually highlight a number of critical differences. A firm that goes bankrupt keeps an intrinsic value, which can be sold by creditors. This is not the case for a country. Aggregate GDP cannot be shipped home by the creditors. Some kind of willingness to pay on the part of the country is always needed.

Moreover, because creditors have no collateral, the value of their claim is proportionate to the harm that they can inflict on defaulting countries. Defaults need to be "bad and ugly" if one wants to deter debtors from reneging on their debt. This is bad *ex post* for the country but may be good *ex ante*, in so far as it may raise the supply of credit. This is one reason why many big debtors such as Brazil are reluctant to participate in a SDRM: they fear that the mechanism would frighten their creditors and precipitate the crisis.

But neither of these arguments is fully convincing. Although it is true that payment always depends on the "willingness to pay" of indebted countries, this willingness, being conditioned by the threat of sanctions, is proportional to GDP or exports, although clearly by a factor less than one. This brings us to the second argument. There are two ways of interpreting "bad and ugly" renegotiations. Payment in full will be preferred over default whenever the debt is lower than a given threshold. Past this threshold, however, the optimum strategy is not to let the country default but to get it to pay an amount below the face value of the debt. This is obviously superior to outright default both *ex post* (the country is perhaps indifferent but the creditors get something) and *ex ante* (since this results in higher lending initially). This is why, like any corporate bankruptcy court, a mechanism that enhances collective rationality of decision-making in case of default should be welcome.

In practice of course, an alternative – a new procedure – must balance *ex ante* and *ex post* efficiency, just as a well-designed bankruptcy procedure seeks to do. That is, it must reconcile the 'sanctity of contracts' – the 'bonding role' of debt – with the restoration of the debtor country's capital market access and economic growth (Eichengreen and Portes, 1995). The latter is the analogue of giving a corporate or personal debtor a 'fresh start', but it also 'preserves value', in the sense that creditors too are better off than with a disorderly process. The justification is well understood in bankruptcy theory, and most codes give considerable emphasis to trying to maintain the financially distressed firm as a going concern (Chapter 11 of the US code goes especially far in this direction). Bankruptcy is clearly not there just to deal with the problem of organizing collective action by the creditors.

It is also necessary to find the 'right' level of difficulty of default – 'as difficult and messy as possible' is not the answer. If the debtor perceives default as infeasible or unacceptably costly, even when an objective assessment would say it is unavoidable, then we see 'gambles for resurrection': policies with some small chance of getting out of the hole but a high probability of a failure that exacerbates the difficulties. The Argentine debt exchange in

summer 2001 is an excellent example. On the other hand, if default is too easy, then we do get moral hazard.

Essential differences between sovereign and corporate debts remain. For firms, bankruptcy is a mechanism that solves the problem of one firm at a time. Even without raising here the problem of contagion crises, a sovereign debt crisis usually involves many (if not all) domestic debtors which have foreign creditors, whether these debtors are themselves solvent or not. If, say, the government suspends its payment, it is likely to generate outright default in the country. In other words the (fear of) default generates a negative externality – which is actually the critical reason why collective action is needed across all classes of creditors and across all classes of debtors (Cohen, 1991). We return below to discuss how this "aggregation" problem should be dealt with in times of crisis.

The collective action problem is the reason why the market cannot itself endogenously generate an appropriate institutional framework for workouts. This is shown by the historical examples of strong government roles in the creation and functioning of the bondholders' committees: the CFB in Britain and the FBPC in the US (Eichengreen and Portes, 1988, 1989). Experience since the Mexican crisis demonstrates conclusively that the private sector cannot design and implement such a framework by itself. On the other hand, the central existing institution – the IMF – cannot be allowed to hijack the process nor even to expand its own role. The Fund already has excessive scope and faces evident conflicts of interest (Portes, 1999). This is generally accepted, as was manifest in the widespread negative reaction to the dominant IMF role envisaged in the November 2001 Krueger proposals for an SDRM.

There is another difference between a country and firm that stems from the lack of transferable collateral. If a country finds it difficult to borrow because of a confidence crisis, then it may be endogenously obliged to default, in effect fulfilling the initial fear. Self-fulfilling debt crises are a phenomenon whose theoretical rationale has been explored in the literature (Calvo, 1988, Cole and Kehoe, 1996, 2000). The intuitive rationale is quite simple: perception of high risk raises the spread, which in turn raises the debt service burden, which in turn provokes the debt crisis. This may happen as a rational equilibrium if the fundamentals out of which a country can service its debt depend partly on its creditworthiness.

If default reduces the amount that a country can service (even reduces this ability to nothing in the case of outright default) then lenders that expect that nothing will be paid do indeed get

nothing. This is less likely in the case of corporate debt if default amounts, say, to changing the management of the firm. Any mechanism that is geared towards maintaining ex post efficiency of the debt workouts is then bound to reduce the risk of a confidence crisis. In particular, a mechanism which guarantees an efficient debt write-off *ex post* can eliminate the risk of a confidence crisis (Cohen and Portes, 2004b). This is one of the key advantages of an orderly workout mechanism: by guaranteeing that *ex-post* resolution of the crisis is efficient, it deters the emergence of *ex-ante* confidence crises.

Everyone recognizes that *disorderly* debt workouts – one or another version of default – are usually very costly to debtors and creditors alike. What could work better, avoiding both bailout and mess? Unfortunately, not the stated policies of the official sector: 'case-by-case with a framework'. The attempt to find an approach lying between clear rules and total discretion has led to a policy that is clearly time-inconsistent and therefore not credible. Both politicians and the markets realize that in many cases – for 'important' countries – there will be unbearably strong pressure on the official sector to swallow its principles and do whatever necessary to avoid a default.

That was evident for Turkey in January 2001, for Argentina in August 2001 and for Brazil in 2002 (an example of a potential self-fulfilling crisis – see Williamson, 2002). That Argentina ultimately became unsustainable and insupportable does not contradict this conclusion, since it was evident long before (indeed, before August 2001) that it *would* become unsustainable, and it was simply a question of when the US and the IMF would officially recognize this and give up. Moreover, the case of Turkey is a particularly good example of how 'private sector involvement' (PSI) simply has not worked – the banks did not cooperate. There has been little success for efforts to limit moral hazard and achieve burden-sharing with bail-ins (Roubini and Setzer, forthcoming).

The first and simplest principle is that big bailout packages cannot and should not continue. IMF resources are stretched, and G7 governments have little appetite for further action at the level of Turkey, Brazil or Argentina. There is also some feeling, though not a clear consensus, that the bailouts from Mexico to Korea, Russia, and those of the past couple of years have left a bad incentive structure for both investors and borrowers – moral hazard, in some form.

It follows that a *rules-based* approach is necessary to achieve any significant PSI. Discretion simply encourages both exit and the expectation of bailouts when exit seems undesirable. In

practice, too, the discretionary approach favoured by the previous US administration too often turned into a procedure in which the IMF implemented whatever the US decided, *ad hoc.* The rules must include clear, *ex ante presumptive limits* on IMF lending, in order to constrain political intervention and reduce moral hazard. It is impossible to implement such rules, however, unless there is a feasible alternative to a default that is deemed to be unacceptably messy. Without such an alternative, a rules-based approach with presumptive lending limits turns out to be time-inconsistent and is abandoned.

Any procedure for resolving sovereign debt problems must sustain the ‘bonding role of debt’ – ‘*ex ante* efficiency’. But if debt restructuring is unacceptably costly to the debtor, that encourages gambling for resurrection. A good procedure, on the other hand, should facilitate the return to growth and capital market access – ‘*ex post* efficiency’. Still, a very low cost to the debtor generates moral hazard. Much of the controversy lies in balancing these two considerations.

Developments since 1994, with a range of financial crises and extensive debates on the international financial architecture, have conclusively demonstrated that the markets will not by themselves generate the institutional framework for effective resolution of sovereign debt difficulties. The great merit of the Krueger proposals is to have reopened the debate and possibly to have led it towards official action that would change existing market institutions.

3. The Krueger (IMF) Proposals

The Krueger proposals of end-November 1991 for a sovereign debt restructuring mechanism (SDRM) came very close to an international bankruptcy court operating under the aegis of the Fund. She and her colleagues then set in motion various studies within the Fund, while receiving reactions from member countries and outside observers. At the beginning of April 2002, Dr Krueger published a revised version of the 'statutory approach' that distanced the new institution from the Fund and gave it less authority to override contracts (Krueger, 2002). It would nevertheless require changes to the Articles of the IMF, as indeed do all subsequent versions of the IMF's proposals.

The key features of the Krueger proposals are the following:

- Majority (supermajority) voting could restructure all the country's debt, and this would be binding on minority creditors

- Disruptive litigation would be deterred by
  - either an automatic stay (standstill) on payments during restructuring
  - or deduction of amounts recovered by any creditor through litigation from its residual claim under agreed restructuring

- Priority would be given to ("debtor-in-possession") financing from new lenders

In the revised IMF scheme, a country that finds it cannot continue to service debt would normally apply to the IMF for a finding of unsustainability. The IMF may then authorise a payment standstill (although the Fund eventually abandoned this element of the proposals), which would entail a stay of creditor litigation, applying to private sector debts too. The debtor would likely have to introduce exchange controls. While a debt restructuring, probably involving some debt relief, is underway, new lending would take seniority over old claims. The debtor and creditors would themselves negotiate the restructuring, but there would be a panel of judges – 'independent' of the IMF – which would have at least the following functions:

- verification of creditor claims
- resolution of disputes
- oversight of creditor voting

Arriving at an agreed restructuring would be much easier if the debt instruments were to include CACs, which therefore form part of the package, although it is recognized that they could apply only to new debt contracts.

4. Difficulties with the IMF proposals

Several key queries and objections have been raised in regard to these proposals. There are well-known limits to the analogy between corporate and sovereign bankruptcy and specifically to an international version of Chapter 11. First, the inability to define the sovereign's 'net worth' or 'liquidation value' entails that the creditors have no well-defined outside option to a settlement, and it is that outside option (the value achieved from liquidation, as set out in Chapter 7 of the US code) that imposes a framework on Chapter 11 negotiations. Second, the Chapter 7 liquidation value gives a standard of reference for 'cramdown' a court-imposed resolution: the judge cannot prescribe a solution that would give any class of creditors less than it would obtain under liquidation. Third, it is hard to define 'debt sustainability' in Chapter 11, just as it would be for a country. Evidence for this is that over 50% of firms exiting Chapter 11 ultimately end up back in reorganization or liquidation. Finally, the new borrowing with seniority allowed under Chapter 11 (debtor-in-possession [DIP] financing) can create its own problems: if the firm's debt is in fact already unsustainable (insolvency), then new financing with priority just 'crowds out' existing creditors – they really do end up worse off than under liquidation.

Market participants, of course, are generally hostile to any measures that would appear to make default 'easier'. Conversely, however, one might ask whether easier debtor access to standstills would cause creditors to exit even earlier and more quickly than they do now. Then, once a standstill had been announced and endorsed, the debtor might have problems obtaining even short-term trade finance, whatever seniority that might attract. It is not clear what sort of IMF financing might be available during a standstill. The Fund adopted some time ago an explicit policy for lending into arrears in appropriate circumstances, but those circumstances and the limits to such lending have not been specified precisely, despite efforts to do so (IMF, 2002).

There is an apparent asymmetry in the proposals: the IMF would be competent to decide that the existing debt burden is unsustainable, but it would not be given authority to determine what reduced level would be sustainable, since this would prejudge the outcome of negotiations. Market participants would indeed see this as the Fund imposing the

(aggregate) terms of a workout. Yet some parameters are needed for negotiations, and many would argue that the Fund is best qualified to set those - just as it does now in estimating a country's 'financing gap'.

The most fundamental, decisive objection to the IMF proposals is that they would require major changes in the IMF Articles of Agreement, which are in effect a treaty that binds member countries. This is politically infeasible for the foreseeable future. Some major emerging market countries have been hostile to any such proposals (including CACs), because they fear a lender reaction that would impair their current market access, and they attach a low ex ante probability to their having to use an SDRM. Decisive, however, is the opposition of the United States. Of course, the European countries, which were broadly more inclined to view the SDRM proposals favourably, do have more votes in the Fund than the United States. But the US has enough to veto. And even a US administration that might wish to amend the Articles to introduce an SDRM would have to seek ratification from the US Congress (the Senate would have the final say). To put to Congress any legislative initiative whatsoever regarding the IMF, however, would entail a risk not merely of defeat, but more seriously, of opening a Pandora's Box containing disparate but powerful waves of hostility to the Fund itself. The potential for a Congressional attack on the IMF – to abolish it, require US withdrawal, end US funding, attach 'wrecking amendments' (anti-abortion, etc.), or at least to prune severely its roles and authority – was evident in the debates that resulted in the Meltzer Commission and in the Congressional reactions to the Commission's report. Deft and diligent work by the Treasury was required to ensure that Congress took no actions to implement the Report, which might have led into very dangerous waters.

5. Obstacles to an international bankruptcy court

It is also useful to review the difficulties facing any version of an international bankruptcy court with teeth. Without a treaty (amendment of the IMF Articles), such a body could not enforce seizure of collateral, if there were any. More seriously, it could not grant seniority to new money (the equivalent of DIP financing under Chapter 11). It could not enforce a cramdown, although the possibility of both cramdown and DIP financing could be provided in new bond covenants and loan agreements. The court could not 'replace management' – indeed, governments would require a guarantee of sovereignty (analogous to Chapter 9 of the US Code, which sets out insolvency procedures for state and local governments). There would be a politically divisive asymmetry, since the industrial creditor countries would doubtless resist putting themselves as debtors under the potential jurisdiction of such a court.

More broadly, we observe that national bankruptcy codes differ widely, specifically on the role of the courts. The highly activist involvement of the bankruptcy judge in US Chapter 11 proceedings, for example, contrasts with the UK, where 'the receiver is king'. It is therefore unrealistic to expect an agreement on a uniform international bankruptcy code, with legislative backup. These tensions and different perspectives were indeed evident in the final discussions of the SDRM by the IMF's Executive Board in 2003.

6. A new institutional framework

A better alternative – and politically easier to implement – is to construct a new institutional framework that would operate in the case of a 'solvency crisis', when debt restructuring would be necessary. In addition to the existing Paris Club and London Club mechanisms, which deal with debt to governments and to banks respectively, there would be a permanent (but 'light') bondholders committee – the 'New York Club', say. It would look not unlike the previous CFB and FBPC. It would oversee bondholders' negotiations with the debtor. And because it would be dealing with all bondholders in simultaneous negotiations under the same umbrella, this institution would go some way towards coping with the aggregation problem.

There might also be a new mediation agency (independent of IMF), as proposed by Eichengreen and Portes (1995) – again, an administratively 'light' structure that would coordinate the Paris Club, London Club, and New York Club, primarily ensuring the timely exchange of information and comparison of assumptions. It would verify claims and oversee bondholder voting. It might take on other roles, *e.g.* endorsing (or not) a proposed standstill. Even more broadly, it could be charged with overseeing implementation of a code of conduct along the lines recently proposed by the Banque de France. This is similar to the International Center for the Settlement of Investment Disputes (ICSID). The proposal of the Institute for International Finance to bring all creditors into a single negotiating committee seems unnecessarily to override existing structures, the Paris and London clubs, that work efficiently. The Paris Club, London Club, New York Club and SDDRF would together, over time, develop a 'code of good practice' for workouts.

There would also be new contractual arrangements: CACs, ultimately extended to all sovereign bonds. An additional contractual innovation that would facilitate restructurings would be to utilize the trust deed form for bonds (common under UK law but not in New York

- see Buchheit and Gulati, 2000). Here the trustee acts for all holders of a given security and centralizes enforcement of any decisions (in particular, the trustee shares among the bondholders the proceeds of any settlement).

7. CACs

Debt contracts are incomplete, and as we have seen, the consequent problems are more severe for international than for corporate borrowing. The institutional and legal structure for sovereign borrowing must respond to this fundamental problem. The broad phrase 'collective action clauses' has been extended to cover a wide range of proposals. As first set out by Eichengreen and Portes (1995) and elaborated recently by Taylor and the G10 Working Party (G10, 2002), these would bring into bond contracts (and indeed to bank lending instruments) a range of clauses that would, we believe, promote orderly workouts of international debt. They could help to avoid the chaotic sequel to default that we have seen, for example, in the Argentine case. These CACs would include

- initiation and engagement clauses detailing how negotiations would proceed
- a clause permitting changes by a qualified majority in the terms of the debt, including amounts and dates payable
- a sharing clause that would require pro-rata distribution to all bondholders of any payment made to any one of them
- and a nonacceleration clause to avoid having one missed payment trigger an immediate full repayment obligation.

It has been objected that including such clauses in international debt contracts would weaken the bonding role of debt and thereby provoke lenders to withdraw, reducing or disrupting market access for countries that now have it or aspire to it. Such objections ignore or dismiss well-supported empirical results from comparisons of 'British-style' bonds, which typically do have such CACs, to otherwise equivalent 'American-style' bonds, which do not. This work shows at most some tendency for terms to 'bad' borrowers to be inferior under the 'British' bonds, whereas the terms to 'good' borrowers (as measured by credit ratings) are in fact better than under the American bonds (Eichengreen and Mody, 2000; Eichengreen, Mody and Kletzer, 2003; Becker, *et al.*, 2002; Guggiati and Richards, 2003).

The most convincing reply to this criticism, however, is to perform the thought experiment of asking what domestic corporate lending would look like without bankruptcy codes. If arrangements permitting the orderly restructuring of debt were abolished, we would surely not observe better terms for borrowers.

The discussion of CACs has progressed to the point where we must be more specific about their content. First, we stress the importance of making CACs as *uniform* as possible. The advantage of ‘boiler plate’ language in a sales contract is that the buyer need not read the small print. He can focus on the key characteristics of the good or service he is buying. These characteristics are what should be reflected in the market price. CACs should become routine, so that they do not even significantly engage the attention of lenders.

Consider going into a restaurant. The contract does not specify the characteristics of the food, service or ambience (except so far as it can be assumed, for example, that the restaurant satisfies public health regulations, employment regulations, and health standards). The contract is that when they bring the bill, you pay – no three months credit with zero interest rate (although they may say beforehand that they do not accept credit cards). The price therefore reflects quality of food, service and décor. That is the information we want prices to convey, information about the fundamentals. The market for sovereign bonds would lose enormously in transparency if pricing had to reflect differences in contractual clauses that buyers have neither the time nor the expertise nor the inclination to price. If Mexico is a better credit than Brazil, because its fundamentals are superior, that should show in the spread, not in permitting a lower supermajority to amend the payment terms. The alternative would have the CACs feature in competition among underwriters, leading to what the investment community could reasonably regard as a deterioration of standards.

So what should be uniform? There are currently alternative ‘model CACs’ proposed by the G10, the ‘Gang of 7’, and the US Treasury. They all identify key clauses as the following:

- engagement clause
- representative (preferably, trustee)
- majority action (with separate thresholds for ‘reserve’ and ‘non-reserve’ matters)
- disenfranchisement (government-held bonds should not vote)
- acceleration and rescission of acceleration
- litigation (to be initiated by representative)
- sharing of proceeds
- information (on request)

These typically are ‘CACs’. Other clauses that are already standard are the pari passu, negative pledge, and cross default clauses. Detailed discussion can be found in the IMF Executive board (2003) discussion of CACs and Roubini and Setzer (forthcoming).

All these should be uniform, with only marginal variations, and should not (need not) be too far from the language in current English-law bonds, because these are already out in the market in substantial volumes (this is consistent with the G10 and US Treasury proposals, but not those of the ‘Gang of 7’ – see Sec. 9 below). Mexico’s February 2003 issue lacks an engagement clause, but there is no reason to believe this was a matter of principle, and it would be desirable for Mexico to include such a clause in its next issue. The one area where market participants might reasonably wish to see differentiation would be in the information clause, which could be more stringent for lower-rated issuers.

Problems remain – for example, how to deal with old bonds that do not include such clauses? Bonds are often exchanged, and this could be facilitated with ‘sweeteners’ if necessary. The New York Club could deal with cross-issue coordination – there is ample historical precedent in the activities of the CFB and FBPC. It seems difficult and perhaps undesirable to have in each instrument a ‘meta-CAC’ that would in effect impose qualified majority voting among all bondholders, whose result would cover all outstanding instruments of a given debtor. The 2003 Uruguay exchange offer did include a provision of this kind, according to which a set of bonds could be restructured with only two-thirds approval by holders of any single bond, provided that 85% (by value) of all bondholders agree to the restructuring**.** The expedient of ‘exit consents’ was used effectively to apply pressure to dissident creditors in the case of Ecuador (Buchheit and Gulati, 2002). Market participants strongly oppose such ‘aggressive’ measures.

The ‘aggregation problem’ is not trivial, but the combination of new institutions and CACs can deal with it satisfactorily. Historically, the institutional framework of the CFB and FBPC did in practice achieve ‘aggregation’. The New York Club proposed here could, for example, resting on an ample body of precedent, bring together and subsume the various groups seeking to negotiate on behalf of Argentine bondholders, whose multiplicity and fractiousness are clearly impeding progress today. And with CACs in all new bonds, new issues and debt exchanges would result in all bonds having CACs within a decade (note that if the process had started in 1996, we would be almost there).

Still, this is the key difference between CACs and the SDRM: the latter would deal simultaneously with all securitised sovereign debt issued in foreign jurisdictions. It would

therefore have to override existing contracts and would therefore require domestic legislation valid in international law, *i.e.* with the force of a treaty – the simplest form of which would be amendment of the Fund's Articles. But that means explicit approval by the US Congress, as well as other national legislative bodies. This will not happen in the foreseeable future. Indeed, the April 2003 meeting of the Executive Directors of the IMF concluded that 'there does not appear to be the requisite support among the Fund membership to establish the SDRM through an amendment of the Fund's articles (IMF Managing Director, 2003). The subsequent meeting of the International Monetary and Finance Committee endorsed this conclusion while saying it 'looks forward to the inclusion of CACs in international bond issues becoming standard market practice and calls on the IMF to promote the voluntary inclusion of CACs in the context of its [Article IV] surveillance'.

8. Standstills

Absent a new, binding international accord – an amendment to its articles – the IMF has no legal authority to declare a standstill that would stay litigation by creditors. That does not, however, preclude it (or a new agency) from issuing an opinion on the justification for a standstill in any given case. That could help to give it legitimacy and at least discourage litigation, especially if the Fund were to adopt guidelines specifying the circumstances in which it would be likely to find a standstill justifiable. To enforce a standstill would require comprehensive exchange controls, and the Fund should be ready to advise a country how best to implement such controls. A court challenge to a block on payments would be likely to take sufficiently long to resolve that meanwhile agreement could be reached under the new orderly workout arrangements.

Here too, we need guidelines on the amounts and duration of IMF lending into arrears. As noted above, such 'debtor-in-possession' financing runs risks – in particular, that the debtor 'wastes' the new money, its position does not improve, and the pre-existing creditors find their position has deteriorated because there are new debts senior to theirs.

An alternative to a conventional standstill is the UDROP (Universal Debt Rollover Option with Penalty) (Buiter and Sibert, 1999). Under this scheme, all foreign currency debt contracts (private and public) would permit the borrower to postpone debt service for a fixed period by paying a pre-specified penalty. Modifications have been suggested (Kenen, 2001): the contract could require that the debtor's central bank would have to declare a 'crunch' before the debtor could activate the clause. And the contract could provide that the government or

the central bank (rather than the individual debtors in the private and public sectors) could take the initiative to activate the UDROP clauses simultaneously for all contracts, under specified conditions.

9. Market participants' views

Representatives of major international investors, speaking in particular under the auspices of the Institute for International Finance (IIF), have from early 1996 opposed most of these measures (IIF, 1996; Portes, 2000). They maintain that 'crisis resolution [should be] based on restoring private sector confidence [and market access]…the 1990s approach…' (IIF, 1999). The argument is again for making default as messy and costly as possible – because, they believe, debtors repay only when the pain of default is unacceptable. They have opposed CACs (until recently); any official endorsement of payments standstills; the pernicious policy of IMF lending into arrears; and the 'aggressive' use of exit consents.

It is not surprising that they have advocated 'relatively large but temporary official support' (IIF, 1999) – 'market confidence is often best catalyzed by substantial commitments of official financing', they say (IIF, 2001).

The views of market participants on collective action clauses have moved significantly over time. Initially, they argued that 'any international attempt to make such clauses mandatory…would convey the impression that the public sector was prepared to facilitate default' (IIF, 1999). More recently, however, they conceded that 'CACs in bond contracts can be useful in facilitating restructuring…and their adoption on a voluntary basis could be encouraged…' (IIF, 2001). The turnabout was completed when the Director of the IIF wrote to the Chairman of the IMF's policy-making body that '…a public-private initiative…(should) advance practical steps…that would lead to the broad-based inclusion of collective action clauses' (C. Dallara, letter to G. Brown, 9 April 2002). One could be forgiven for conjecturing that this reappraisal simply saw CACs as a less undesirable alternative to the proposals that were coming from the Fund.

Indeed, perhaps the main achievement of the SDRM proposals is to have given market participants a strong incentive to cooperate with the 'decentralized, contract-based' alternative. Under this pressure, a group of six associations of private sector financial institutions announced in June 2002 agreed 'market-based principles' that they proposed for crisis management and debt restructuring. And in February 2003, they proposed their version

of ‘model CACs’. These proposals, however, are more than even-handed – they take away with one hand what they concede with the other. Their provisions for amending financial terms are more restrictive than those already existing in English-law bonds, while their proposals for amending non-financial terms are more restrictive than those in New York law bonds (Roubini and Setzer, forthcoming).

Market participants often maintain that the emerging market countries themselves oppose CACs. This has been to some extent true, but it may result from the interaction between the New York investment houses and the borrowers in a market structure of oligopolistic competition. The underwriters have counselled borrowers against CACs. Some of them say privately that this is only because the conventional view of the borrowers, albeit unjustified by any empirical test, is that they would get worse terms if they were to include CACs. And, say the underwriters, they cannot push CACs against issuer resistance when competing for a mandate because the competition will tell the issuer that CACs are unnecessary and undesirable. But to the extent that the underwriting houses themselves believe this, they should note that bonds without CACs do not give any extra protection against bailins when things go wrong – they just mean extra hassle (as in the case of Ukraine).

Market participants have also said that the SDRM is attacking the insolvency problem, whereas in fact illiquidity crises are more common and more serious; that the SDRM is simply the Fund’s way of trying to protect its own position as a senior creditor; and that both SDRM and CACs threaten the sanctity of contracts, will create unacceptable levels of moral hazard, and will thereby raise the cost of capital for emerging market borrowers (see above).

Are these their true motivations in opposing the SDRM and CACs? Issuers clearly are concerned about the possibility of higher spreads, whatever the empirical work may say, and they want to demonstrate that they have no ‘fallback’ position. Both issuers and underwriters are trying to sell bonds and fear the chilling effect of ‘prenuptial agreements’. Most important, however, is that lenders expect bailouts as long as there is no alternative, established procedure for PSI. As long as the official sector provides bailout packages, there is no incentive for the markets to want CACs; but there must be bailouts in the absence of an alternative that would limit the costs of default. There is a ‘chicken-or-egg’ problem – one might indeed call it ‘CACs 22’.

There are signs, however, that the opposition is eroding. Mexico, whose central bank governor had previously been a prominent sceptic on CACs, took the initiative to issue a new sovereign bond with CACs in February 2003. It was then followed by Brazil in April 2003,

then by South Africa and Uruguay. The market priced these issues apparently without regard to the ‘new’ clauses. We may finally have reached the end game.

10. How to proceed

The official sector has supported CACs since 1996, with gradually increasing commitment. Market participants are accepting them, however grudgingly. The remaining resistance from market participants and borrowers should be ignored. The private sector (banks and investment houses) does not want a ‘mandated regime’ and never will. That includes mandatory CACs. But to be fully effective, such provisions must be quasi-universal. The G7 Action Plan does not yet go far enough to bring any action. We still, therefore, have no organized, acceptable alternative to bailouts.

Pressure from the official sector and the examples just noted may be sufficient to bring general acceptance. If not, there is a relatively simple, feasible way of implementing our proposals (Portes, 2000). The mandates of the American Securities and Exchange Commission (SEC) and the British Financial Services Authority (FSA) include duties to protect investors and to maintain orderly markets. Although these institutions resist any such interpretation, it could be taken as sufficient justification and authority, without new legislation, for them to intervene. It is clear from the case of Argentina that those markets were and are disorderly and that investors have not been adequately protected against the eventuality of default by having adequate post-default procedures in place. In countries where CACs might require new legislation (Germany, Japan), this should be initiated.

The American, British and other major financial centre regulatory authorities should therefore stipulate that bonds issued or traded in their markets must include CACs and other workout-friendly clauses. The IMF could organize and indeed help to fund a voluntary exchange program (with enhancements) for outstanding stocks of securities without such clauses. And the Fund should make access to the SRF (indeed, any Fund programme) open only to countries that use CACs. Given the resistance, it would require substantial pressure from the US and UK Treasuries to proceed in this way. If the markets do not now generalise the recent examples, however, the official sector should not hesitate to act. In practice, US and UK action would probably suffice.

11. Conclusion

Considerable progress has been made since November 2001. The Krueger speech and the US response to it removed substantial blocks to action.. The problem is primarily implementation. Here a decentralized, voluntary approach simply will not work across the board. Both historical examples and the record of the past few years demonstrate this conclusively.

The SDRM debate has been extremely useful but seems now to have fulfilled its role of stimulating progress towards implementation of feasible proposals, in particular CACs. Meanwhile, the official acceptance that the SDRM is itself not feasible has undermined its credibility as a threat. Other pressures for implementation must take its place. And even if the markets now move to universalise CACs, other institutional innovations like a New York Club are required to support them. These too need more than simple encouragement from the official sector. If there is no determined action, we shall not be ready for the next wave of crises – which will surely come.

References

Becker, T., A. Richards and Y. Thaicharoen, 2002, Bond restructuring and moral hazard: are collective action clauses costly?, IMF Working Paper 01/92, forthcoming in *Journal of International Economics.*

Buchheit, L., and G. Gulati, 2000, “Exit Consents in Sovereign Bond Exchanges”, *UCLA Law Review* **48**, pp. 59-84.

Buchheit, L. and G. Gulati, 2002, “Sovereign Bonds and the Collective Will”, Working paper 34, Georgetown University Law Center.

Buiter, W., and A. Sibert, 1999, ‘UDROP : a Contribution to the New International Financial Architecture’, *International Finance* **2**, 227-247.

Calvo, G., 1988, ‘Servicing the Public Debt: The Role of Expectations’,*American Economic Review* **78**, 647-661.

Cohen, D., 1991, *Private Lending to Sovereign States,* MIT Press.

Cohen, D., and R. Portes, 2003, *Crise souveraine: entre prévention et resolution*, CAE Rapport no. 43, September 2003, Documentation Française.

Cohen, D., and R. Portes, 2004a, ‘Dealing with Destabilizing “Market Disicipline”’, CEPR DP 4480.

Cohen, D., and R. Portes, 2004b, ‘Towards a Lender of *First* Resort’, CEPR DP 4615.

Cole, H., and T. Kehoe,1996, ‘A Self-fulfilling Model of Mexico’s 1994-1995 Debt Crisis’, *Journal of International Economics* **41**, 309-30.

Cole, H., and T. Kehoe,2000, ‘Self-Fulfilling Debt Crises’, *Review of Economic Studies*, **67**, 91-116.

Eichengreen, B., and A. Mody, 2000, “Would Collective Action Clauses Raise Borrowing Costs?”, NBER Working Paper 7458.

Eichengreen, B., K. Kletzer, and A. Mody, 2003, ‘Crisis Resolution: Next Steps’, IMF Working Paper.

Eichengreen, B., and R. Portes, 1988, ‘Foreign Lending in the Era of Bond Finance: the Bondholders' Perspective’, CEPR Discussion Paper No. 273, appeared in French as ‘Les prêts internationaux dans l'entre-deux-guerres: le point de vue des porteurs de titres’, *Economie Appliquée* 41, pp. 741-771.

Eichengreen, B., and R. Portes, 1989, ‘After the Deluge: Default, Negotiation and Readjustment in the Interwar Years’, 1989 (with B. Eichengreen), in B. Eichengreen and P. Lindert (eds.), *The International Debt Crisis in Historical Perspective*, MIT Press, pp. 12-47.

Eichengreen B., and R. Portes, 1995, *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors*, London, Centre for Economic Policy Research.

Fischer, S., 1999, 'Reforming the International Financial System', *Economic Journal* **109**, 557-76.
Gugiatti, M., and A. Richards, 2003, Do collective action clauses influence bond spreads? New evidence from emerging markets, Research Discussion Paper 2003-02, Reserve Bank of Australia
G10, 1996, *The Resolution of Sovereign Liquidity Crises,* Bank for International Settlements.
G10, 2002, *Working Group on Contractual Clauses*, Bank for International Settlements.
Institute of International Finance, 1996, *Resolving Sovereign Financial Crises,* Washington.
Institute of International Finance, 1999 *Report of the Working Group on Financial Crises in Emerging Markets*, Washington.
Institute of International Finance (2001),
International Monetary Fund, 2002, "Fund Policy on Lending into Arrears to Private Creditors – Further Consideration of the Good Faith Criterion", at http://www.imf.org/external/pubs/ft/privcred/073002.htm.
International Monetary Fund (Executive Board), 2003, at www.imf.org/external/np/sec/pn/2003/pn0353.htm
International Monetary Fund (Managing Director), 2003, Report to the International Monetary and Financial Committee on a Statutory Debt Restructuring Mechanism, 8 April 2003, at www.imf.org/exgternal/np/omd/203/040803.htm
Kenen, P., 2001, *The International Financial Architecture : What's New ? What's Missing?*, Institute for International Economics.
Krueger, A., 2001, 'International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring ', Washington DC : American Enterprise Institute.
Krueger, A., 2002, 'New Approaches to Sovereign Debt Restructuring, an Update of our Thinking', Washington DC.
Meltzer (Commission): http://www.bicusa.org/usgovtoversight/meltzer.htm
Portes, R., 1999, 'An Analysis of Financial Crisis: Lessons for the International Financial System', in W. C. Hunter, *et al.*, eds., *The Asian Financial Crisis: Origins, Implications, and Solutions*, Kluwer Academic Publishers.
Portes R., 2000, 'The Role of Institutions for Collective Action', pp. 47-73 of C. Adams, R. Litan, R., and M. Pomerleano, eds., *Managing Financial and Corporate Distress: Lessons from Asia*, Brookings Institution, Washington DC.
Rogoff, K., and J. Zettelmeyer, 2002, 'Bankruptcy Procedures for Sovereigns: a History of Ideas, 1976-2001', *IMF Staff Papers* **49**, 470-507.
Roubini N., and B. Setser, 2004, forthcoming**,** *Bailouts or Bail-ins? Responding to Financial Crises in Emerging Economies*, Institute for International Economics.

Sachs, J., 1995, ‘Do we Need an International Lender of Last resort?’, Frank D. Graham Memorial Lecture, Princeton University.
Taylor, J., 2002, ‘Sovereign Debt Restructuring: a US Perspective’,
http://www.treas,gov/press/releases/po2056.htm.
Williamson, J., 2002, *Economic Policy Brief*, Institute for International Economics.