ADDRESSING COLLECTIVE-ACTION PROBLEMS IN SECURITIZED CREDIT

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I

INTRODUCTION

Over the first half of the 1980s, the composition of new international credit shifted from mainly syndicated bank loans to predominantly capital-markets instruments—that is, securitized credit.[1] As of the end of 2008, 84% of all credit in the United States was provided via capital-markets instruments with only 16% provided via bank loans.[2] Although a higher percentage of credit is provided through bank lending in the Eurozone (44%) and in the United Kingdom (46%), the share provided via credit-market instruments has been rising in those regions as well.[3] Over the past ten years, a substantial percentage of that capital-markets-based financing has taken the form of private-label, asset-backed securities. Global private-label securitization soared from almost nothing in the late 1990s to peak at close to five trillion dollars in 2006.[4] These trends in the international securitization of credit have presented a number of challenges for the prevention and containment of financial crises, and accordingly for managing systemic risk.

One consequence of securitization is that the wide and increasingly international sale and distribution of securities disperses credit ownership. This distribution has a potential benefit of reducing the concentration of credit in any single credit provider. But the dispersion also has the certain consequence of spreading the effects of an adverse credit event widely when it occurs. The wide dispersion of ownership across diverse investors with disparate interests

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This article is also available at http://www.law.duke.edu/journals/lcp.

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1. *See generally* PAUL W. FEENEY, SECURITIZATION: REDEFINING THE BANK 9–28 (1995) (discussing the trends in securitization of credit).

2. BD. OF GOVERNORS OF THE FED. RESERVE, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: FLOWS AND OUTSTANDINGS, SECOND QUARTER 2009 (2009), *available at* http://www.federalreserve.gov/releases/z1/20090917/z1.pdf.

3. MCKINSEY GLOBAL INST., GLOBAL CAPITAL MARKETS: ENTERING A NEW ERA 22, 23 exhibit 20 (2009).

4. INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT 5, 84 fig.2.2 (2009) [hereinafter GFSR].

can also make it difficult to achieve the authorizations or agreements needed for an orderly resolution of severely distressed debt.

If the potential negative effects of debt default on financial markets and the real economy are substantial, this collective-action problem in resolving distressed debt is not solely a concern of the affected debtors and creditors, but it becomes a public-policy concern. Whenever an issuer of debt instruments is subject to a statutory and judicial regime that provides a framework for equitable restructuring of debt or an orderly liquidation in bankruptcy, the potential for disorder and contagion are reduced. In the absence of such a legal regime, contractual or other institutional arrangements may provide a substitute framework for reorganization of debts.[5]

The collective-action problem in restructuring sovereign debt in the 1990s and early 2000s was one aspect of securitization that made the sovereign debt crises of those years more difficult to resolve than the comparable problems of the 1980s. The collective-action problem appeared again as a hindrance to containing the current subprime crisis. In both cases, the lack of an effective framework for creditors and debtors to address severe financial distress caused by significant levels of debt had negative implications for the international economy. The financial and legal structures of securitized credit failed to anticipate the potential for such severe distress and, when it occurred, there was no clear path to resolve it. Thus, in both the sovereign debt and subprime crises, containing the risk caused by a major credit event became more difficult and called for significant public resources to mitigate the adverse effects.

Since the onset of the current financial crisis, much has been written about what needs to be done to prevent similar catastrophes in the future. Preventing and containing systemic risks in the international financial system will require a host of reforms in terms of macroeconomic and financial policies, financial-system structure and regulation, and institutional governance and performance in both the public and private sectors.[6] One lesson from the sovereign debt crises of the past, however, is that credit mechanisms lacking a framework for

5. For a discussion of these arrangements, see for example, Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565, 576.

6. *See, e.g.*, FIN. SERV. AUTH., THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS (2009), *available at* http://www.fsa.gov.uk/pubs/other/turner_review.pdf [hereinafter TURNER REVIEW]; GROUP OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY (2009), *available at* http://www.group30.org/pubs/recommendations.pdf; INT'L MONETARY FUND, THE RECENT FINANCIAL TURMOIL—INITIAL ASSESSMENT, POLICY LESSONS, AND IMPLICATIONS FOR FUND SURVEILLANCE (2008), *available at* http://imf.org/external/np/pp/eng/2008/040908.pdf; Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund (October 11, 2008), *available at* http://www.imf.org/external/np/cm/2008/101108a.htm; Declaration [of the G-20] Summit on Financial Markets and the World Economy (Nov. 15, 2008), *available at* http://www.g20.org/Documents/g20_summit_declaration.pdf; Summit Communiqué of the G-20: The Global Plan for Recovery and Reform (Apr. 2, 2009), *available at* http://www.g20.org/Documents/final-communique.pdf; Press Release, U.S. Treasury, Treasury Outlines Framework for Regulatory Reform (Mar. 26, 2009), *available at* http://www.treasury.gov/press/releases/tg72.htm.

orderly resolution of severely distressed debt are an invitation to financial crisis. Because securitized credit is likely to remain an important segment of international finance, and because securitizations inevitably make collective action more complex,[7] both market participants and systemic-risk overseers need to proactively assure that the mechanisms are in place to resolve distressed debt even in extreme events.

II

HOW SOVEREIGN DEBT CRISES WERE RESOLVED IN THE ERA OF SYNDICATED BANK LOANS

It is useful to consider how the framework for resolving international financial crises functioned in the 1980s, when most credit was provided through commercial bank loans. Although the challenges for crisis management seemed Herculean at the time, neither the added complexities of large volumes of sovereign debt evidenced by capital-markets instruments (which occurred in the 1990s), nor a financial market driven by advanced financial engineering (as we have today), were yet factors in managing systemic risk.

A number of economic, financial, and political factors resulted in the buildup of high levels of external debt by a number of developing countries in the late 1970s and early 1980s. Much of the debt was U.S. dollar–denominated, and the interest payments had floating rates linked to the London Interbank Offered Rate (LIBOR). Once the United States and a number of other industrial countries adopted substantially tighter monetary policies to control inflation in the early 1980s (affecting interest rates and exchange rates), the debt burdens of these countries became unsustainable. First Mexico in 1982,[8] then Brazil, Argentina, Chile, the Philippines, and a number of other countries in Latin America and Eastern Europe were effectively unable to meet their foreign debts when contractually due.[9]

The majority of that debt took the form of commercial bank loans that were generally syndicated by the internationally active money-center banks to a broader segment of the banking community in the United States and abroad. The original sources of these funds were the balance-of-payments surpluses of the oil-exporting states. The international banking system "recycled" the

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7. *See* GFSR, *supra* note 4, at 2–3.

8. Poland defaulted on approximately eight billion dollars in external debt in March 1981, but the size and scope of the global crisis attracted heightened government concern when Mexico's difficulties became known. LEX RIEFFEL, RESTRUCTURING SOVEREIGN DEBT: THE CASE FOR AD HOC MACHINERY 102, 156 (2003).

9. *See, e.g.*, WILLIAM R. CLINE, INTERNATIONAL DEBT: SYSTEMIC RISK AND POLICY RESPONSE 1–19 (1984) (describing the origins of the 1980s debt crisis and its resolution); PAUL A. VOLCKER & TOYOO GYOHTEN, CHANGING FORTUNES: THE WORLD'S MONEY AND THE THREAT TO AMERICAN LEADERSHIP 187–227 (1992) (same).

petrodollars, and the oil-exporting countries thereby indirectly financed much of the debt arising from the higher oil-import bills of developing countries.[10]

The potential defaults on the very sizeable obligations of the debtor countries posed risks to the international financial system as a whole in two ways. First, in many cases, the loans made by the major money-center banks to sovereign borrowers dwarfed the capital available to those banks for reserves or write-offs of the troubled debts. Thus, if defaults on the debt owed to these banks occurred, an "old fashioned" banking crisis was a possibility. Second, if all of the insolvent debtor countries had to make the economic adjustments necessary to quickly generate the resources needed to meet all outstanding debt, such an abrupt retrenchment could severely harm not only their domestic economies, but all the economies to which they were linked globally. Thus, the imminent default, first by Mexico and then by many others, was a public-policy concern that required concerted action to prevent these negative consequences for the financial system and the global economy.[11]

With the leadership of the International Monetary Fund (IMF) and the United States, the public sector and the international banking community worked to develop a process for an orderly resolution of the crisis—in particular, a mechanism to give banks the time to boost their earnings and their capital to absorb the risks on their books, and the debtors the time to take the economic-adjustment measures needed to restore external viability. In most cases the IMF had a critical role in assessing the credibility of the debtor's economic-adjustment program and determining what level of adjustment or belt-tightening was achievable. The IMF program essentially established how much external financing would be needed during the adjustment period. The IMF had some resources to help meet those needs and some other official-sector funds might have been forthcoming, but the sizes of the "financing gaps" for these debtors could not be met by government assistance alone. Moreover, the public sector was not disposed as a policy matter to "bailing out" the imprudent decisions of the marketplace. Essentially, the IMF program defined the size of the contribution that the commercial-bank lenders were expected to make—thus the term "bail-out" was properly replaced with the term "bail-in."[12]

The large money-center banks—with substantial loans to sovereigns potentially in default, and with their reputations as major syndicate leaders further at stake—were motivated to work with the public sector within the foregoing framework to resolve the crisis. As the "agent banks" in the syndicated credits, they had responsibilities to collect and distribute payments on the loans for the hundreds of other banks in their syndicates and to convey important information to the other banks. But they had authority neither to amend key financial terms in the loans on their own nor to obtain net new

10. VOLCKER & GYOHTEN, *supra* note 9, at 187–227.

11. CLINE, *supra* note 9, at 21–29; RIEFFEL, *supra* note 8, at 155–56.

12. CLINE, *supra* note 9, at 29–32; VOLCKER & GYOHTEN, *supra* note 9, at 200–07.

financing from banks in the syndicate. Thus, even in the simplified world of commercial-bank loans as the main channel of credit, there were collective-action challenges to resolving distressed debt.[13]

The banks were experienced in addressing distressed corporate credits, though, and they used that model to organize creditor committees vis-à-vis each debtor country, both as a point of contact and discussion with the debtor and as a channel of communication with other creditors. The committees and their chairmen also became important points of contact with the IMF and other public-sector collaborators in the resolution of the crisis. One of the most difficult hurdles was to persuade all the banks in the syndicates to put in their proportional share of new money commitments. To facilitate the process, the public sector used a number of carrots—such as regulatory forbearance on the reserving rules on those loans—and sticks—such as IMF threats not to disburse its own funds without a critical mass of committed private-sector financing. Over time, as serial restructuring of each country's debt began to wear down the patience of all the participants, multi-year restructurings took their place. Over a seven-year period, more of the bank lenders had a chance to rebuild earnings and capital, and several were actively looking for a way to transform their bank loans into more-liquid assets. Many were anxious to spend fewer resources and less time on the crisis in less-developed countries and to focus on other business.[14]

In 1989, the Brady Plan was launched by the U.S. Treasury. Under that plan, bank loans were converted to marketable, collateralized bonds. Those exchanges resulted in the banks' writing off a portion of the debt principal or reducing interest payments, and improving the banks' credit risk through collateral arrangements. By this time, Citibank had unilaterally declared a write-down of another twenty percent of the face value of the sovereign debt on its books, and a number of other banks followed, giving them considerable flexibility in future restructurings. Thus began a period of debt forgiveness and the "securitization" of sovereign debt. As more restructurings created even more-varied and interesting securities in the "exchange offers" for outstanding loans, an active trading business in all of the debt instruments flourished. Over time, new groups of investors (for example, mutual funds, pension funds, and insurance companies) in emerging-markets debt developed as the debtor countries' economic and financial strength grew and the potential returns appeared more attractive. The debtors thus began obtaining substantial

13. *See* 1 CURRENT LEGAL ISSUES AFFECTING CENTRAL BANKS ch. 7 (Robert C. Effros ed. 1992).

14. *See* Andrew Yianni, *Proposed New Approach to Sovereign Debt Restructuring*, XII CENTRAL BANKING 3, 84–86 (2002); *see also* RIEFFEL, *supra* note 8, at 95–131, 162–68 (discussing the Bank Advisory Committee process for restructuring sovereign debt owed to commercial banks); VOLCKER & GYOHTEN, *supra* note 9, at 207–19 (discussing the aftermath of the Latin American crisis).

amounts of new financing through international bond issues as a routine part of their public finance.[15]

The crisis resolution framework of the 1980s shared a number of key elements:

> 1. Although the bank loans were widely syndicated, making restructuring of the distressed debt more complex, all the lenders were commercial banks. Most had suffered similar regulatory and accounting consequences from defaults or restructuring decisions, all had experience with and accepted the concept of debt work-outs, and all held claims of equal rank or priority. Thus, reaching agreement on the terms of a restructuring was aided by the creditors' essentially similar interests.
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> 2. In lieu of a bankruptcy regime for assuring an independent assessment of the fairness of restructuring the debtor's and the creditors' interests, an IMF program gave some assurance to the creditors that the debtor was engaged in good-faith economic reforms and that a third party monitored ongoing progress on those reforms to provide some confidence that the restructured loans would be repaid when due.
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> 3. The syndicated loans themselves had provisions to ease agreement on the restructuring terms and to discourage free riders. A key provision was that any recoveries by any individual creditor had to be shared among all creditors *pari passu* (facilitating collaborative actions). Moreover, to discourage debtors from catering to hold-outs, the agreement included mandatory prepayment provisions, which provided that if a bank eligible to participate in a restructuring agreement did not do so and obtained better terms, the banks that had agreed to the restructuring agreement could generally insist on the same terms as the hold-out bank. Although some hold-outs appeared in reschedulings, these tended to be sufficiently minor, so that the deals got done and life moved on.[16]
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> 4. The public and private sectors cooperated to resolve the crisis in the context of an equitable framework—the debtor countries had to undertake significant economic adjustments, the creditors had to provide significant net financing to allow an orderly adjustment period, and the broader international community provided some bridge financing, some regulatory forbearance, and the institutional imprimatur of the IMF to give the process credibility.

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15. RIEFFEL, *supra* note 8, at 168–77; VOLCKER & GYOHTEN, *supra* note 9, at 207–19.

16. At a late stage in the Brady bond restructurings, some agreements also included provisions by which key financial terms could be amended by specified majority votes (albeit a 75–85% majority), thereby allowing for a "cramdown" of the restructuring terms on nonconsenting minority creditors.

Thus, in the era of syndicated commercial-bank credit, a framework existed for working out distressed sovereign debt in an orderly way without jeopardizing the financial system as a whole and leaving the public sector with the enormous financial consequences of such an event.

III

THE COLLECTIVE-ACTION PROBLEM IN SECURITIZED SOVEREIGN DEBT

Mexico's debt crisis of 1994 and how it was resolved demonstrate stark differences with the preceding era. In contrast with the 1980s, by 1994, credit was obtained by sovereigns in much larger amounts through the capital markets than through traditional bank loans, and the levels of that debt grew as emerging-market economies grew. As countries increasingly saw the benefits of this financing, global capital markets became much more open and unregulated. The bondholders of emerging-market debt in the 1990s included financial institutions (holding the debt in both trading and investment accounts), other institutional investors (such as mutual funds, pension funds, and insurance companies looking for diversification and higher yields), expatriates, and retail investors (typically in those countries without customer "suitability" requirements in their regulation of brokers and investment advisors, or where such requirements had not been observed). Investors were not only geographically diverse, but given the nature of their various institutions, their motivations and the time horizons were vastly so, as were differences in the regulatory and accounting rules affecting their holdings and potential restructuring of the bonds they owned. Moreover, many of the investors held their investments through third parties, so determining the identity of the beneficial owners could be difficult.[17]

When Mexico's political turmoil and financial difficulties led to a potential default on fifteen billion dollars of short-term, external government bonds in the spring of 1994, the U.S. Treasury became concerned about the shock this default could cause to the financial system and its potential spill-over effects on other countries. The shock would come partly from the 1980s practice of excluding bond indebtedness from sovereign debt restructurings. Such exclusion was possible when bonds were a small portion of a country's overall indebtedness. There were difficulties as well in applying the restructuring paradigm of the 1980s to the 1994 crisis: there were no creditor committees of bondholders to organize a standstill and negotiate a restructuring agreement; the terms of the Mexican bond contracts (governed by New York law) had no "majority action" provisions, so every bondholder had the legal right to accelerate debt in default and sue to recover; and the variety of locations and

17. RIEFFEL, *supra* note 8, at 190–93; GROUP OF TEN, THE RESOLUTION OF SOVEREIGN LIQUIDITY CRISES ¶¶ 10–15 (1996), *available at* http://www.bis.org/publ/gten03.pdf?noframes=1 [hereinafter Rey Report].

interests of the various classes of bondholders made reaching a relatively quick and orderly resolution exceedingly difficult.[18]

In these circumstances, the United States led the international official community in supporting a fifty-billion-dollar rescue package to staunch capital outflows from Mexico, with the effect of bailing out Mexico's bondholders (as well as financing other such "capital flight"). Notwithstanding the international community's aim of preventing contagion to other countries, the crisis shattered investor confidence in other emerging-market borrowers and caused severe restrictions on capital-markets access for Argentina, Brazil, and others.[19]

Although the international community collaborated to provide this massive public-sector support to Mexico in 1994, the moral hazard its action posed to maintaining financial discipline in debtor countries and among international investors led to extensive discussion on how to improve the sovereign debt crisis-prevention and crisis-resolution framework. Moreover, the magnitude of international capital flows to emerging-markets countries dwarfed the available amounts of public-sector resources, making public bailouts of all countries that might face capital flight increasingly difficult as a practical matter, even if this had been viewed as acceptable as a policy matter. After the Asian debt crisis and the Russian default in the late 1990s, the pressure for substantial reform became even greater. Russia's financial crisis in 1998 was the clearest example of moral hazard in action. For a number of years in the lead-up to the crisis, the IMF and the international public sector supported Russia with a series of IMF programs on which Russia failed to perform. When the IMF finally pulled the plug and stopped lending in 1998, Russia defaulted on its massive debt to the private sector. Its investors had continued to provide financing, notwithstanding plenty of solid information on Russia's dire financial condition, in the belief that Russia was "too nuclear to fail"—that is, the investors assumed that they would in the end be bailed out as Mexico was in 1994. The shock of Russia's default caused a true international financial crisis, with a massive flight of investors to the safety and quality of U.S. Treasury securities and little else.[20]

From 1996 through 2000 a flurry of public- and private-sector proposals were made (and a number of concrete actions in fact taken) to strengthen the architecture for sovereign debt crisis prevention and resolution.[21] Most had these elements in common:

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18. PETER B. KENEN, THE INTERNATIONAL FINANCIAL ARCHITECTURE: WHAT'S NEW? WHAT'S MISSING? 19–26 (2001); RIEFFEL, *supra* note 8, at 198–202; Rey Report, *supra* note 17, at ¶¶ 36–45, 53–65.

19. By 1995, Mexico did adopt a strong economic-adjustment program and moved to a more flexible, essentially floating exchange rate, repaid its debt to the IMF and bilateral official creditors, restored a sustainable balance of payments position, and attained renewed access to international capital markets. RIEFFEL, *supra* note 8, at 198–202.

20. *See, e.g.*, KENEN, *supra* note 18, at 26–47; RIEFFEL, *supra* note 8, at 203–11.

21. *See, e.g.*, INT'L MONETARY FUND, REVIEWING THE PROCESS FOR SOVEREIGN DEBT RESTRUCTURING WITHIN THE EXISTING FRAMEWORK (2003), *available at* http://www.imf.org/external/np/pdr/sdrm/2003/080103.pdf.

> 1. A recognition that crisis resolution is far more complex when a wide variety of institutional and individual investors hold sovereign debt;
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> 2. An acceptance, therefore, that crisis prevention was even more important than in the past, and this required a number of improvements in economic- and debt-sustainability surveillance by the IMF, financial-system regulation and supervision, data gathering and disclosure by debtors to their investors, and "self-insurance" by the debtor countries;
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> 3. A recognition that bondholders could not expect to be "senior" or their holdings classified as "excluded" debt when a sovereign's debt load became unsustainable and needed to be restructured (this point was emphasized by the 1999 restructuring of the bonds issued by Pakistan); and
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> 4. A recognition that a framework was needed to make an orderly restructuring of sovereign-bond indebtedness less complex (notwithstanding the restructuring of sovereign bonds in a number of sovereign-bond exchanges that occurred over this period in conjunction with large IMF programs of support).

In this regard, the Group of Ten's 1996 Rey Report[22] first recommended that sovereign bonds include the same types of collective-action clauses that were standard in English-law-governed Eurobonds, including those issued by sovereigns.[23] These clauses would allow for majority action to restructure financial terms and to accelerate the debt repayment only by a decision of the majority, not by individual creditors; the clauses would also require pro rata sharing of any recoveries made by individual creditors should they take action by litigation, set-off, or otherwise. Such modifications should facilitate orderly restructurings. In contrast to English-law-governed bonds, New York–law-governed sovereign bonds had been patterned on the forms used for corporate bonds issued in accordance with the Trust Indenture Act.[24] That Act gave extensive protections to individual bondholders, including protections for minority bondholders.[25]

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22. Rey Report, *supra* note 17, at 46–47.

23. For a discussion of the collective-action clauses in English-law-governed Eurobonds and a comparison with New York–law-governed bonds, see Andrew Yianni, *Resolution of Sovereign Financial Crises—Evolution of the Private Sector Restructuring Process*, FIN. STABILITY REV., June 1999, at 80–81.

24. *See* Anna Gelpern & Mitu Gulati, *Public Symbol in Private Contract: A Case Study*, 84 WASH. U. L. REV. 1627, 1683–84 (2006); Rey Report, *supra* note 17, at 45–46.

25. *See* Gelpern & Gulati, *supra* note 24, at 1683–84. In the corporate bond context, these protections were not inappropriate, as U.S. bankruptcy-code provisions assured equitable treatment of debtors and various classes of creditors in a corporate reorganization.

It was not until the Argentine financial crisis in 2001—and a series of failed IMF-approved economic programs—that the public sector became more assertive about the need to improve the framework for sovereign debt restructurings.[26] In addition to the Argentine crisis, a series of large IMF programs and support packages—for Brazil and Turkey, in particular—had signaled the need for a system under which the private sector made a greater contribution to crisis avoidance and resolution.[27]

In the fall of 2001, two key alternative proposals for improving the sovereign debt-restructuring framework were put forward: the Sovereign Debt Restructuring Mechanism (SDRM) and the adoption of Collective-Action Clauses (CACs) in sovereign bonds. The SDRM—first proposed by First Deputy Managing Director of the IMF, Anne Krueger—would give the IMF a more intrusive role in the debt-restructuring process and, most importantly, would allow the IMF to "sanction" a standstill in the payment of sovereign debt when necessary to facilitate an orderly restructuring. The investor community was vehemently opposed to this plan, especially due to this potential suspension of their basic contract rights. The issuers, for their part, were concerned that the plan would increase their costs of financing and indeed might scare off the capital markets to a large extent.[28]

The alternative, market-based solution proposed by the Under Secretary of the Treasury, John Taylor, was for the market participants to include CACs (along the lines proposed in 1996 in the Rey Report) in all future sovereign bond offerings.[29] Thus, bondholders would effectively recognize that their claims were not exempt from restructuring and that they had a responsibility to work with the debtor in distress for an orderly resolution of debt problems. For their part, issuers would recognize that they had a responsibility to work with their creditors in advance of extreme distress and that the international official community should not be the presumed savior. There was a continued recognition of the role of IMF programs and of reasonable, finite amounts of official resources in support of such a restructuring.

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26. RIEFFEL, *supra* note 8, at 251–56. Argentina's crisis led to a massive default in early 2002 on forty-seven billion dollars of external debt as well as default on its domestic debts. It is not clear that any improved restructuring framework would have made Argentine debt resolution orderly in view of the country's complex and difficult politics, its soured relations with the IMF at that time, its diversity in geography and type of bondholders holding the debt, and the sheer extent of economic adjustment required. Argentina's political, economic, and financial problems had become extreme due to its failure to confront at an earlier date the intractable external imbalances produced by a fixed exchange-rate regime. *See* JOHN B. TAYLOR, GLOBAL FINANCIAL WARRIORS: THE UNTOLD STORY OF INTERNATIONAL FINANCE IN THE POST-9/11 WORLD 70–97 (2007).

27. NOURIEL ROUBINI & BRAD SETSER, BAILOUTS OR BAIL-INS? RESPONDING TO THE FINANCIAL CRISES IN EMERGING ECONOMIES 61–63, 65–66 (2004).

28. *See generally* RIEFFEL, *supra* note 8, at 250–53, 266–71 (discussing Krueger's role upon arriving at the IMF and the features of the SDRM); Gelpern & Gulati, *supra* note 24, at 1631.

29. TAYLOR, *supra* note 26, at 111–18; John B. Taylor, Under Sec'y of Treasury for Int'l Affairs, Sovereign Debt Restructuring: A U.S. Perspective, Remarks at the Institute for International Economics Conference: Sovereign Debt Workouts: Hopes and Hazards? (Apr. 2, 2002), *available at* http://www.treas.gov/press/releases/po2056.htm.

The active and serious discussion at the IMF of the SDRM no doubt had a motivating role in getting investors and issuers to increasingly consider the use of CACs. Yet the discussions ended up in a complete standoff between the issuers and investors in September 2002, for many reasons: The investors were a diverse group, including "vulture" funds whose modus operandi was to buy distressed sovereign debt at a deep discount and to sue for recovery of the face value once restructuring talks were imminent or underway (and who therefore strongly opposed creditor contract provisions under which a majority could determine the fate of all those holding relevant instruments), more-traditional distressed-debt investors, emerging-market-debt traders, and a wide range of institutional investors. Each class of investors had unique financial interests dependent on its motivations for investment, other business interests in the emerging markets, and accounting and regulatory regimes. So each class sought different tradeoffs for any documentation concession to issuers. The sovereign issuers, for their part, objected to many of the investor tradeoffs, and by requesting the adoption of CACs, they did not want to imply that they had any intention to default on their debt in the future. Moreover, they were concerned about the effect of such clauses on their cost of borrowing.[30]

After the standoff, in the interests of the international financial system as a whole, the U.S. Treasury in particular became much more active in cajoling issuers to take the leap individually or collectively to issue their new international bonds with CACs. It was not until February 2003 (over seven years after the Rey Report recommendations) that Mexico courageously led the way with an SEC-registered global note containing CACs. By moving first, it took the risk of increased funding costs, but it also gained the advantage of setting the terms of the new clauses. As it happened, the market did not impose any cost for the documentation changes on Mexico or on any of the other sovereign issuers who followed. The other benefit of Mexico's action was that the SDRM was pulled off the IMF's work agenda, and the constant talk of potential sovereign defaults—which might chill market access—was put to an end.[31]

At about the same time, Uruguay (which had suffered contagion from Argentina's 2001 debt default) had successfully negotiated a restructuring of its debt in the context of an IMF program and thus had avoided default. As in the 1980s, the IMF program affirmed the acceptable parameters of Uruguay's economic adjustment, thereby defining the financing gap that needed to be filled during the adjustment period, and Uruguay worked with the public and private sectors to fill the gap. Uruguay completed its 2003 debt-exchange offer, which was sufficient to meet the private-sector contribution to the needed financing. Moreover, the debt exchange was adopted at a very high acceptance

30. TAYLOR, *supra* note 26, at 127–30; Gelpern & Gulati, *supra* note 24, at 1631.

31. TAYLOR, *supra* note 26, at 127–30; Gelpern & Gulati, *supra* note 24, at 1631.

rate by investors and included in the new bond offerings CACs with no cost to the issuer.[32]

Thus was established the framework for crisis resolution for sovereign debt, including sovereign bonds. Although this framework does not assure that sovereign debt crises will be avoided or that contagion from one country to others will not occur, it at least provides a path for avoiding default and for avoiding a chaotic resolution of distressed debt in the future.

This experience with the securitization of sovereign debt offers several lessons:

1. Securitization created a great diversity and variety in the interests of the sovereign's creditors, making resolution of a financial crisis more difficult and complex;

2. This necessitated far greater attention to crisis prevention on the part of the sovereign borrowers as well as the international community;

3. For these capital-markets activities to continue without jeopardizing the stability of the international financial system as a whole, there needed to be a framework acceptable to the relevant market participants for addressing distressed debt in a reasonably orderly way even in cases of extreme distress; and

4. Creating a stronger crisis-prevention and resolution framework required the active collaboration of the private and public sectors. Moreover, there was a clear need for the public sector to drive reforms: the differing interests of diverse market participants, each of whom would be motivated primarily by private advantage and not the public good, were unlikely to produce the results required for the safety of the financial system as a whole.

These lessons needed to be applied more broadly as the international financial system grew more complex in the years that followed.

IV

THE SUBPRIME CRISIS AND THE COLLECTIVE-ACTION PROBLEM

Securitization of credit has reached new dimensions of complexity in the current decade. In the 1990s, we were coping with the mere conversion of bank loans to sovereign bonds sold in international capital markets. This created far less-difficult risk-management challenges than the securitization of credit through advanced financial engineering, which characterizes the financial

32. *See, e.g.*, INT'L MONETARY FUND, *supra* note 21, at 33–34.

markets today. These challenges are well illustrated in the private-label[33] residential-mortgage-backed securities (RMBS) market.

The U.S. subprime residential mortgages, at the heart of the current global financial crisis, were pooled into special purpose vehicles or trusts, against which securities were issued and sold to diverse investors around the world. The securities were often "tranched" to create different priorities for different classes of investors respecting the trust assets, increasing the complexity of these securitizations. In some cases, securities were enhanced by third-party guarantors or swap providers—who themselves had a specified priority of claim on the trust. Further complexity could be added by pooling the trust securities themselves into another trust, usually with the effect of increasing the leverage in the structure and diversity of investor interests. If the trusts—which typically held assets with long maturities—were funded in part by short-term borrowing, as was often the case, substantial liquidity risk was added to credit risk in the structures.[34]

The transfer of credit risk on the residential mortgages from the originators (generally banks or specialized mortgage lenders) to a wide range of other investors was thought to make the financial system safer—that is, the transfer should result in less risk concentration and therefore a greater capacity of the market to absorb the credit risk on the assets. In fact, the complexity, opaqueness, and the financial and legal structure of this credit mechanism caused serious credit deterioration in a fairly narrow segment of world financial markets (the U.S. subprime residential-mortgage market) to become the source of a major financial panic and global recession.[35]

At the heart of the subprime crisis was a seriously flawed, sometimes fraudulent, underwriting process that created high-risk residential-mortgage loans that were repackaged, sold, and often repackaged again, into securities carrying investment-grade bond ratings. The structure and pricing of the securitizations and their credit ratings were premised on flawed risk models, often using historical loss ratios on prime mortgages. The mortgages themselves were overly leveraged, as were the trusts against which the securities were issued and the third-party guarantors that enhanced these structures. The risks in these products were inadequately disclosed; diligence by investors, guarantors, and ratings agencies was inadequate; and, when the bubble burst, information was lacking as to where these widely sold and potentially toxic assets resided throughout the international financial system. When the U.S. residential-real-estate bubble burst and the credit ratings on the RMBS were

33. These are the residential-mortgage-backed securities created by sponsors other than government-sponsored entities such as Fannie Mae and Freddie Mac.

34. PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, POLICY STATEMENT ON FINANCIAL MARKETS DEVELOPMENTS 1–9 (2008), *available at* http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf [hereinafter PWG 2008]; Randall Dodd, *Subprime: Tentacles of a Crisis*, IMF FIN. & DEV., Dec. 2007, at 15–19.

35. GFSR, *supra* note 4.

lowered, fear about the size, scope, and distribution of the potential credit losses led to a financial panic characterized by heavy asset liquidations and a global flight to quality. Thus, the credit excesses in the U.S. subprime residential-mortgage market became magnified and distributed globally by virtue of the securitization process used.[36]

The legal and financial structure of the RMBS made the crisis exceedingly difficult to resolve. First, the complexity and opaqueness of the securitization structures made it very hard to ascertain the fair value of these assets and thus determine the true financial condition of the financial institutions carrying them on their books. Thus, determining how best to deal with the impact of the crisis on the financial sector and credit markets was likewise extremely difficult.[37]

Second, addressing the underlying problem of bad mortgage loans and the risks to the economy of widespread foreclosures was more difficult, still. The collective-action problem for orderly resolution of the distressed debt in the RMBS trusts was far more complex than that confronted in the sovereign-bond restructurings of the 1990s. Like the sovereign debt of the 1990s, RMBS were not subject to a bankruptcy or other established regime that would create a framework for a reorganization of the underlying debt. The RMBS were intentionally structured so that the trusts were "bankruptcy remote," and the underlying mortgage loans in the trusts also had certain protections from modification in bankruptcy. Thus, it was the contract terms of the RMBS that determined the structure for dealing with distressed debt in the trusts.[38]

The collective-action problem in resolving distressed debt in the trusts was not one of merely organizing highly diverse and dispersed investors (much like the problem in the sovereign bonds of the 1990s), but of dealing with investors with different priorities of claims against the trust issuer. In addition, the distressed assets were themselves claims on a multitude of debtors and involved diverse collateral in the form of individual home mortgages. So a collective-

36. PWG 2008, *supra* note 34; INT'L MONETARY FUND, THE RECENT TURMOIL—INITIAL ASSESSMENT, POLICY LESSONS, AND IMPLICATIONS FOR FUND SURVEILLANCE 1–10, (2008), *available at* http://www.imf.org/external/np/pp/eng/2008/040908.pdf; TURNER REVIEW, *supra* note 6, at 11–28.

37. It was much harder to stabilize the financial system following the current crisis than it was following the sovereign debt crisis of the 1980s, when banks and regulators could fairly quickly determine the risk exposures of individual banks and the amount of capital needed to rebuild their balance sheets. In contrast, in 2008 and 2009, the Bush Administration and the Obama Administration, as well as governments of foreign countries whose financial systems were adversely affected, struggled to determine which institutions had large risk exposures, how to measure potential losses, and whether capital infusions or government programs to purchase "toxic assets" or government guarantees of bank debt could best address the risks to the global financial system. Bank for Int'l Settlements, *BIS Quarterly Review*, Dec. 2008, at 10–11, *available at* http://www.bis.org/publ/qtrpdf/r_qt0812.pdf; Henry M. Paulson, Jr., U.S. Treasury Sec'y, Remarks at The Ronald Reagan Presidential Library (Nov. 20, 2008), *available at* http://www.treas.gov/press/releases/hp1285.htm; U.S. Treasury Department, *Fact Sheet: Financial Stability Plan*, Feb. 9, 2009, *available at* http://www.financialstability.gov/docs/fact-sheet.pdf.

38. Anne Gelpern & Adam Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities*, 82 S. CAL. L. REV. 1075, 1117 (2009).

action problem affected not only the diversity of the investors but also the diversity of the debtors and the collateral supporting the debts.

The contracts that governed the RMBS reflected the practical reality that individual investors needed to delegate to an agent the ability to deal with assets in the trust that were in default or that might potentially default.[39] The servicer of the loans, who collected and disbursed payments to the trust and investors, was typically delegated that responsibility in the Master Pooling and Servicing Agreement (MPSA). The terms of the RMBS, including the MPSA, were designed to maximize investor interest in acquiring the securities, including obtaining the highest credit ratings possible. Moreover, unlike the debtors of sovereign bonds, the ultimate "debtors" of the assets in the trust (that is, the homeowners with mortgages in the trusts) had no voice in designing what procedures would be applied should their ability to repay or refinance their obligations become seriously impaired. For both these reasons, the terms of the MPSA were clearly investor friendly.[40] Further, in an economic environment in which housing prices seemed ever on the rise, the sponsors of the securitizations and the credit-rating agencies that facilitated the growth of the business adopted a financial and legal framework for the RMBS that assumed default rates based on historical averages in the U.S. residential-mortgage markets (which had been dominated by prime lending, not the more-recent subprime standards).[41] And they surely did not contemplate or provide for the contingency of widespread defaults, market contagion, and a severe economic downturn.

It is not surprising, therefore, that the MPSAs had a number of features that made orderly workouts of distressed residential mortgages held by the trusts particularly difficult. Some contracts severely limited the scope of the servicer's rights to make material modifications in the mortgage-loan terms, particularly in advance of an actual default. Others may have granted broad discretion, but in doing so failed to establish a clear standard for servicer conduct. In both cases, the servicer was concerned about liability and thus was reluctant to act (particularly when there were competing creditor priorities, such that any action would likely favor one class of creditor over another). Indeed, there were no established industry or contractual standards by which the performance of servicers dealing with distressed debt in RMBS trusts would be judged; yet the trustees on behalf of bondholders had the authority to replace the servicers. The manner in which the servicer was compensated also affected the actions it

39. A default by a mortgagor on an asset held by the trust does not trigger a default on the RMBS. Rather, the rights of the investor vis-à-vis the servicer, and the rights and duties of the servicer when such a default occurs are set out in the contract terms.

40. Gelpern & Levitin, *supra* note 38, at 1124; Larry Cordell et al., *The Incentives of Mortgage Servicers: Myths and Realities* 3 (Federal Reserve Board Finance and Economics Discussion Series, Staff Working Paper No. 46, 2008); John P. Hunt, *What Do Subprime Securitization Contracts Actually Say About Loan Modification?*, BERKELEY LAW, UNIV. OF CAL. CTR. FOR LAW, BUS., AND THE ECON. 1 (2009).

41. PWG 2008, *supra* note 34, at 14; INT'L MONETARY FUND, *supra* note 36, at 6–7.

was willing to take: reimbursement for out-of-pocket foreclosure expenses was often more easily collected than the administrative costs of negotiating a workout. And because the sponsors of and investors in securitizations did not contemplate the potential for extreme debt distress, many servicers lacked the personnel and resources, no less the expertise, to handle potential workouts on the scale that materialized in this crisis.[42]

Some of the foregoing obstacles to mortgage workouts were addressed at least in part by the U.S. government and by the mortgage industry. Congress authorized government payments to compensate servicers for some of the added costs of workouts. And the mortgage industry agreed on standards for acceptable workout options to facilitate quicker responses and to mitigate servicer-liability risk.[43] Nonetheless, problems persisted in addressing the distressed debt and in preventing foreclosures.

The longer the delay in resolving the distressed-mortgage debt, the higher the rate of home foreclosures, and the greater the downward pressure on home prices. This in turn exacerbated the financial-industry distress and economic-feedback effects on the economy, thereby deepening the crisis.[44] Part of the problem in preventing foreclosures as the crisis played out was that the persistent decline in home prices and increasing unemployment made many debtors likely to be either unwilling or unable to service restructured loans, even with substantial financial concessions. In both cases, the option of foreclosure would likely appear preferable to servicers and investors.[45]

The subprime crisis reinforces the lessons from the sovereign debt crises of the 1980s and 1990s regarding the costs of the collective-action problem posed by securitized credit: First, securitization creates a diversity of investors (and in the case of pooled assets, a diversity of debtors as well), making more complex and difficult the resolution of distressed debt; and the more complex and opaque the structures and diverse the investor interests, the greater these difficulties are. Second, crisis-prevention measures are therefore all the more important. For example, credit standards need to be robust and observed; risk

42. Cordell et al., *supra* note 40, at 6; Gelpern & Levitin, *supra* note 38, at 1126.

43. For guidelines developed for handling currently distressed mortgages and government programs for payments to servicers and other incentives for restructuring distressed mortgage debt, see, for example, Hope Now Alliance 2008, http://www.hopenow.com; Press Briefing with Treasury Secretary Geithner, HUD Secretary Donovan, and FDIC Chairman Bair (Feb. 18, 2009), *available at* http://www.whitehouse.gov/the_press_office/Press-Briefing-with-Treasury-Secretary-Geithner-HUD-Secretary-Donovan-and-FDIC-Cha/.

44. Press Release, U.S. Dep't of the Treasury, Relief for Responsible Home Owners (Mar. 4, 2009), *available at* http://www.ustreas.gov/press/releases/tg48.htm.

45. For an analysis of lender and servicer behavior in renegotiating distressed mortgage debt, see Renae Merle, *Foreclosures are Often in Lenders' Best Interest*, WASH. POST, July 28, 2009, at A1; Manuel Adelino, Kristopher Gerardi & Paul S. Willen, *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization* (Fed. Reserve Bank of Boston, Public Policy Discussion Papers No. 09-4, 2009), *available at* http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf. For a discussion of the ways in which the U.S. laws governing personal bankruptcy may affect debtor and creditor motivations for voluntary work-outs of residential mortgage debt, see Levitin, *supra* note 5.

must not be disguised through overly complex and opaque instruments; risk needs to be properly compensated; leverage must not be excessive; risk models should not be based on flawed historical data and should incorporate the potential of extreme risk events; and market, liquidity, and credit risks all must be soundly assessed.[46] Third, credit mechanisms must provide a framework for resolving distressed debt in an orderly way. No matter how intelligently risk appears to be managed, credit and market risks can cause unanticipated defaults. A framework that is not adequate to address a situation of extreme distress is an invitation to financial crisis. And fourth, the public-sector overseers of systemic risk[47] need to be proactive in assuring that the crisis-prevention and crisis-resolution frameworks are in place for credit provided through traditional banking channels, through the capital markets, or by other mechanisms of financial intermediation. As we learned with the sovereign debt of the 1990s and with the RMBS instruments of today, it is incorrect to assume that market participants, in pursuit of their diverse private interests, will take the actions needed to adequately address risks to the system as a whole.[48]

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46. *See* GFSR, *supra* note 4. In the United States, federal legislation and regulations have been proposed or adopted to address many of these risks in the structure of mortgage–backed securities and other asset–backed securities. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank]; 17 C.F.R. §§ 200, 229, 230, 232, 239, 240, 243 and 249, Asset Backed Securities, Securities Act Release No. 9117, Exchange Act Release No. 61,858 (proposed Apr. 7, 2010); Advanced Notice of Proposed Rulemaking Regarding Treatment by the FDIC as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation, May 11, 2010 [hereinafter FDIC Proposal]. In addition, the industry participants in these markets have proposed changes to industry practices in the comprehensive Project Restart; *see generally* http://www.americansecuritization.com/restart; *see also* GFSR, *supra* note 4 (critiquing actions by the private and public sector to strengthen the architecture of the RMBS market). These are important steps in crisis prevention affecting the securitized credit that was at the heart of the current financial crisis.

47. *See* Summit Communiqué of the G-20, *supra* note 6 (setting forth the new role of the Financial Stability Board); Press Release, Treasury Outlines Framework for Regulatory Reform, *supra* note 6 (focusing on management of systemic risk by a designated systemic risk regulator for the U.S.).

48. The public sector is just beginning to address issues related to resolution of distressed securitized debt and debt created through the burgeoning global derivatives markets. The FDIC Proposal seeks to address the contractual provisions affecting the restructuring of distressed assets contained in securitized pools. FDIC Proposal, *supra* note 46. However, these rules would only apply where insured banks are the transferors of the assets. The Dodd-Frank Act contains provisions to reduce systemic risk from arising from the settlement of distressed derivatives contracts by requiring increased use of central clearinghouses and exchanges. Dodd-Frank, *supra* note 46. Also, CFTC Chairman Gary Gensler has drawn attention to the way in which credit derivatives may impede the resolution of distressed debt in corporate bankruptcy. Gary Gensler, OTC Derivatives Reform, Keynote Address at Market's Outlook for OTC Derivatives Conference (Mar. 9, 2010). All of these legislative and regulatory initiatives are important steps in making U.S. financial markets and international financial markets less susceptible to systemic risk.