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The Constructive Role of Private Creditors

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During the past couple of years, policy-makers in Washington and other capitals of G-7 countries have been flogging the idea that the functioning of the world's financial markets must be improved by making it easier for insolvent governments, especially in emerging markets, to obtain debt relief from their bondholders and bankers.

Most savvy investors, financial intermediaries, and emerging-market government officials, however, are at a loss to understand why the G-7 and the International Monetary Fund (IMF) believe the international financial system would function better if there were specific mechanisms to facilitate sovereign bankruptcies.

The main reason U.S.–chartered corporations that cannot pay their creditors subject themselves to wrenching reorganizations before entering into, or once under, Chapter 11 of the U.S. bankruptcy code is that the alternative is their outright liquidation under the code's Chapter 7. Sovereign governments, in contrast, do not operate under the threat of liquidation, and despite the strong rights that bondholders have on paper under New York, British, and other law, practical experience indicates that the enforcement of claims against sovereign governments is exceedingly difficult. Whereas delinquent corporations can be hauled, de jure and de facto, before a bankruptcy court and be forced to change management, restructure operations, dispose of assets, or even liquidate to pay off claims, governments are not subjected to any of that. Chapter 9 of the U.S. bankruptcy code is similarly unhelpful as a model for how to restructure the liabilities of bankrupt governments, since it does not apply to sovereign entities, such as U.S. states and counties, which under the U.S. Constitution are ensured to remain free of federal government interference.[1]

Consequently, those in the business of issuing, underwriting, or investing in sovereign bonds are generally of the view that, if anything, international reforms should focus on making contracts easier to enforce and on facilitating the constructive involvement of bondholders and other private-sector creditors in debt-

[1] Chapter 9 applies to nonsovereign entities such as municipalities, school districts, and publicly owned utilities. For a discussion of why Chapter 9 provides little guidance in the case of sovereigns, see Michelle J. White, "Sovereigns in Distress: Do They Need Bankruptcy?" *Brookings Papers on Economic Activity* 1 (2002), pp. 287–319.

restructuring negotiations.[2] Yet the G-7 has not called for any actions or penalties against irresponsible governments, such as the attachment of their official international reserves when they are on deposit with central banks like the U.S. Federal Reserve or with the Bank for International Settlements, the central banks' central bank. At present, for example, the investors who have filed suits against Argentina in New York and other jurisdictions because of the default that took place more than a year and a half ago cannot get their hands on the billions of dollars that the government of that country has sheltered in those G-7 institutions. The G-7 initiatives have not contemplated any incentives—let alone principles or procedures—for ensuring that governments become more accountable for their financial obligations.[3] The intent of the initiatives is wholly one-sided: to expedite the granting of debt relief on the part of bondholders and other private-sector creditors.

THE RECORD SPEAKS

Although various proposals for resolving debt crises have been advanced, they all suppose that the lack of collective action among private-sector lenders and investors is the main obstacle to the smooth functioning of the international financial system.[4]

Yet there is little if any empirical support for this claim. On the contrary, private creditors have been much more progressive, flexible, and quick in dealing with sovereign insolvency situations than have been official lenders—and the gap in their different responses is growing. In fact, private lenders have provided a good example for how official bilateral and multilateral lenders might themselves deal more fairly and effectively with sovereign insolvency situations.

The absence of innovative mechanisms has not impeded several landmark workouts of sovereign indebtedness. The governments of Ecuador, Pakistan, Russia, and the Ukraine, for example, have all been able to restructure their bonded

[2] See, e.g., Institute of International Finance, Inc., "Principles for Private Sector Involvement in Crisis Prevention and Resolution" (Washington, D.C.: Institute of International Finance, Inc., January 2001); available at www.emta.org/ndevelop/iif-psi.pdf.

[3] Nor, of course, have they even mentioned the idea of subjecting troubled debtor governments to outside intervention of the type that New York City, for example, had to accept when it could not pay its bills in the early 1970s.

[4] According to the first deputy managing director of the IMF, a new approach to sovereign debt restructuring is needed because "in the current environment, it *may* be particularly difficult to secure high participation from creditors as a group, as individual creditors *may* consider that their best interests would be served by trying to free ride . . . . These difficulties *may* be amplified by the prevalence of complex financial instruments . . . which in some cases *may* provide investors with incentives to hold out . . . rather than participating in a restructuring" [emphasis added]. See Anne O. Krueger, *A New Approach To Sovereign Debt Restructuring* (Washington, D.C.: International Monetary Fund, April 2002), p. 8; available at www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf.

debt in recent years—and have done so in record time. Substantial debt-service relief and even sizable debt forgiveness have been obtained through the use of exchange offers, often accompanied by bondholder exit consents that encourage the participation of as many investors as possible in take-it-or-leave-it settlements. Rather than amending bond covenants, the exchange offers typically entail the debtor government presenting its private creditors with a menu of voluntary options, such as accepting new bonds for a fraction (for example, 60 percent) of the principal owed but paying a market interest rate, or new bonds for the original principal but paying a concessional interest rate. Experience has demonstrated that neither the threat of litigation nor actual cases of litigation have obstructed these debt restructurings, which have involved large, institutional as well as small, retail investors throughout the world.[5]

The latest case involves the government of Uruguay, which earlier this year asked investors to consider a debt-restructuring request, and more than 90 percent of them agreed, enabling the operation to be consummated in a matter of several weeks.[6] The Uruguayan authorities previously spent many months debating the nature of the restructuring with the IMF. The IMF wanted Uruguay to default on its obligations to bondholders just like Argentina had done, with the intention of obtaining massive debt forgiveness from private creditors, but the Uruguayan authorities refused to go down this potentially ruinous path. The government wanted to pursue, instead, a market-friendly debt exchange with the sole purpose of stretching out the maturities falling due in 2003 and the next several years, while respecting the original amounts owed and continuing to make the requisite interest payments. It was only after the Uruguayan authorities sought and obtained support from the U.S. Treasury and the Federal Reserve that the IMF staff backed down and agreed to support a voluntary debt exchange.[7]

Once an understanding between the IMF and Uruguay was reached, matters moved rather quickly. Informal discussions with private creditors were held in March of this year, a concrete proposal was put forth in April, investor replies were received in May, and by June Uruguay's bonded debt had been successful-

[5] For useful background information on sovereign debt defaults and restructurings, see World Bank, *Global Development Finance 2003: Striving for Stability in Development Finance*, vol. 1 (Washington, D.C.: World Bank, 2003), pp. 56–79; available at www.worldbank.org/prospects/gdf2003/GDF_vol_1_web.pdf.

[6] See the statement by the U.S. attorneys for Uruguay, Cleary, Gottlieb, Steen & Hamilton, "Uruguay in Groundbreaking $5.2 Billion Debt Restructuring," Press Release, May 29, 2003; available at www.cgsh.com/newsworthy-categories.cfm?strNwsCatName=Restructurings.

[7] See the TV interview with President Jorge Batlle of Uruguay, "El Default Significaba el Quiebre Institucional de Uruguay," July 4, 2003; available at www.presidencia.gub.uy/sic/noticias/archivo/2003/julio/2003070404.htm. This version of events had previously been revealed by Vice President Luis Hierro of Uruguay, but had been denied by the IMF's spokesman; see IMF, "Transcript of a Press Briefing by Thomas C. Dawson," June 26, 2003; available at www.imf.org/external/np/tr/2003/tr030626.htm.

ly restructured. This was accomplished despite the fact that the investor base was scattered around the globe: the operation involved from retail investors in Argentina and Japan to institutional investors in the United States and Europe, all of whom were bound by contracts written in several jurisdictions, each with its own currency and distinct legal features.

The cases of Bolivia, Nicaragua, and Ecuador, with which this author had some involvement, highlight the difference between how private and official creditors have treated governments in serious financial trouble. Back in 1988, commercial bank creditors first forgave nearly 90 percent of what the government of Bolivia owed them, and in 1993 they wrote off nearly 85 percent of the then-remaining principal.[8] In contrast, the country became eligible for debt relief from official bilateral and multilateral creditors under the original Highly Indebted Poor Countries (HIPC) initiative a full decade later, in September 1998, and under the Enhanced HIPC initiative only in June 2001.[9]

In 1995, commercial bank creditors forgave more than 90 percent of what the government of Nicaragua owed them. In contrast, official bilateral creditors represented by the Paris Club canceled less than 55 percent of the outstanding obligations at about the same time, with no debt relief coming from the multilateral agencies. The country never became eligible for debt relief under the original HIPC initiative, and will not qualify for the benefits of the Enhanced HIPC initiative prior to 2004, although the Paris Club creditors recently agreed to cancel the equilvalent of one-fourth of Nicaragua's remaining debt obligations.[10]

In 1995, private creditors also granted a mix of debt and interest forgiveness to the government of Ecuador, as part of a comprehensive Brady-style settlement. Creditors accepted the choice of either writing off 45 percent of the principal owed while stretching out the maturity dates for repayment of the remainder for thirty years, or charging highly concessional interest rates for thirty years. The holders of nearly 60 percent of the total debt chose to provide principal relief, while the remainder chose to provide long-term interest-rate forgiveness. When Ecuador experienced acute economic difficulties again in 1999, the IMF made it clear to the government that it would not get any help from the official community unless it

[8] For a detailed discussion of this and the following cases, see Institute of International Finance, Inc., "Survey of Debt Restructuring by Private Creditors" (Washington, D.C.: Institute of International Finance, Inc., April 9, 2001), p. 5 (Bolivia), pp. 21–23 (Ecuador), and p. 45 (Nicaragua).
[9] On HIPC relief for Bolivia and other countries, see World Bank, "HIPC Initiative: Status of Country Cases Considered Under the Initiative, April 2003," April 2003; available at www.worldbank.org/hipc/progress-to-date/status_table_Apr03.pdf.
[10] See Paris Club, "The Paris Club and Nicaragua Agree to a Debt Restructuring under the Enhanced Heavily Indebted Poor Countries Initiative," Press Release, December 13, 2002; available at www.clubdeparis.org/rep_upload/PR01.pdf.

defaulted to private creditors and obtained debt forgiveness once again.[11] Shut out of IMF and other official financial support, the government had no choice but to declare a default. Before long, Ecuador's bondholders were formally requested to grant permanent debt relief—and by August 2000 they had forgiven about 40 percent of what was owed to them.

In contrast, official bilateral and multilateral lenders have not granted any debt forgiveness to Ecuador. The country was deemed by the IMF to be insolvent enough to deserve write-offs from private creditors—but not poor enough to deserve write-offs from the official development community. Paris Club creditors have therefore agreed merely to reschedule about one-third of debt-service payments falling due between May 2000 and May 2001 and between March 2003 and March 2004 according to the Houston Terms, the least generous of all Paris Club poor countries' debt treatments. Thus Ecuador has continued to be charged mostly market interest rates and is expected to repay the bulk of its obligations as they mature.[12] Meanwhile, it is still business as usual at the multilateral agencies: they have not rescheduled, never mind forgiven, any of Ecuador's debt, and they have provided little new money. In fact, from 2000 to 2002, amortization payments by Ecuador to the multilateral agencies exceeded disbursements from those agencies.[13] Once interest payments made to the multilateral agencies are factored in, it becomes clear that Ecuador has made substantial net transfers to the official community.

THE G-7'S UNDERLYING RATIONALE

What then is the rationale of the G-7 and the IMF in devoting so much time and effort to facilitating future workouts of sovereign debt to private creditors? Apparently, G-7 and IMF officials are trying to ameliorate the undesirable consequences of their recent practice of bailing out certain troubled sovereign debtors with multi-billion-dollar rescue packages. Stung by criticism of these bailouts, and worried about having encouraged too many countries with looming debt crises to come knocking at their door pleading for last-minute help, the G-7 governments have

[11] This is based on frank, off-the-record conversations with IMF and Ecuadorian officials. For the IMF's version of the events, see Stanley Fischer, "Ecuador and the IMF," May 19, 2000; available at www.imf.org/external/np/speeches/2000/051900.htm.

[12] See Paris Club, "The Paris Club Agrees to a Debt Restructuring for Ecuador," Press Release, September 15, 2000; available at www.clubdeparis.org/rep_upload/ec15092000cpen.pdf; and Paris Club, "The Paris Club Agrees to a Rescheduling of Ecuador's Debt," Press Release, June 13, 2003; available at www.clubdeparis.org/rep_upload/PR0123.pdf.

[13] See International Monetary Fund, "Ecuador: Selected Issues and Statistical Appendix," IMF Country Report No. 03/91, April 2003, p. 112; available at www.imf.org/external/pubs/ft/scr/2003/cr0391.pdf.

wanted to open up an alternative for themselves—a fast track to default, debt forgiveness (at least by private lenders), and financial resurrection. Thus, when in the future an overindebted government that is not strategically important approaches the G-7 for emergency financial help, it will no longer be able to claim that it must get billions of dollars because the alternative is a hopelessly disruptive, delayed, and uncertain default with potential spillover effects around the globe. With some kind of sovereign bankruptcy procedure in place, the G-7 would feel freer to tell that government to seek debt forgiveness from its private creditors, instead, on the belief that a relatively painless and quick debt restructuring would follow.

From late 2001 until early 2003, the IMF staff worked feverishly on a proposed Sovereign Debt Restructuring Mechanism (SDRM) that, however, has not yet gained the necessary political support among a number of governments, including the United States. Its earlier versions envisioned a powerful role for the IMF that would have allowed it to make decisions limiting creditors' rights. In the face of universal criticism from private-sector lenders and investors, the IMF's role was later toned down to the equivalent of the sole expert witness, by passing judgment on how much debt any government could reasonably be expected to service. In this capacity, the IMF and its G-7 shareholders on its executive board would have a procedural advantage that would allow them to protect their claims and influence the amount of debt relief granted by private creditors.

The planned SDRM was not accompanied, however, by a proposal to address what has really undermined the functioning of the international financial system in recent years: the multibillion-dollar G-7 and IMF rescue packages that have been put together for strategically important countries since 1995. Thanks to the string of bailouts involving countries from Mexico to South Korea, and from Brazil to Turkey, the possibility that a country may get a huge package of financial support with which to meet its debt obligations has become one of the key elements in the assessment of sovereign creditworthiness. Many credit ratings, analyst recommendations, and investment decisions are based on assumptions about whether a foreign government is viewed with favor by the White House, Downing Street, or another G-7 government. The situation is akin to picking stocks or bonds for a portfolio not on the basis of whether a weak company will manage to turn itself around, but rather on whether it will be nursed back to health via an infusion of large-scale government support. How could the U.S. financial markets possibly function well if state intervention, as in the case of the Chrysler bailout of 1979–80, had become commonplace?

A counterproposal put forward by the U.S. Treasury and endorsed by many investors and financial intermediaries is a much better alternative. It represents a contractual rather than statutory approach to sovereign bankruptcy situations, involving the introduction of new clauses into bond contracts to facilitate the debt restructuring process. The main idea is that every bond contract should designate a bondholder representative to act as an interlocutor with the sovereign debtor; require the sovereign to provide more key financial information to its bondholders; allow for a supermajority of bondholders to amend payment terms, now often requiring unanimity of consent; and include enforcement provisions that concentrate the power to initiate litigation in a single jurisdiction.[14] These new clauses have become widely known as collective action clauses (CACs), and while several already exist in bonds issued under U.K. law, most new and outstanding bonds of emerging-market sovereigns are issued in other jurisdictions, such as New York and Frankfurt, where such clauses are not customary.

Most emerging-market issuers and investors were initially reluctant to introduce CACs in new bond contracts for fear of signaling that they contemplate or countenance an eventual default. Besides, even if such clauses are introduced voluntarily in all new debt issues, the stock of outstanding bonds would still be governed by preexisting legal arrangements, so that their practical effect will be marginal for years to come. Under strong pressure from the U.S. Treasury, however, the governments of Mexico and Brazil were persuaded earlier this year to issue new bonds with CACs, and they were successfully placed with institutional investors at no measurable extra cost. Governments such as those of South Africa and South Korea followed suit, although each sovereign bond issued so far carries its own particular clauses that do not incorporate all of the language recommended by official and private-sector groups. Consequently, a uniform market standard in CACs is yet to develop.

While wider inclusion of CACs into sovereign bond contracts will probably do no harm, it is doubtful that even their widespread application will make a visible difference to the workings of international finance. Of much greater significance would be a G-7 decision to scale back the massive official support to certain errant debtor nations. If the IMF were to go back to providing seed money for economic and policy turnarounds on as objective a basis as possible, this alone would encourage governments and their creditors to consider much more seriously the implications of falling into the abyss of default—regardless of whether improved sovereign bankruptcy mechanisms are instituted. Moreover, it is patently unfair that some governments should be lavished with official aid and others should be

[14] See Group of Ten, "Report of the G-10 Working Group on Contractual Clauses," September 26, 2002; available at www.bis.org/publ/gten08.pdf.

starved, when the IMF is supposed to be a cooperative to which its member governments should be able to turn for fairly automatic, albeit limited, help.

In addition, the very notion of a quick and painless debt restructuring is problematic both on an ethical and practical level. Ethically there should not be, I believe, such a thing as a fast track to default, debt forgiveness, and financial resurrection. The smoother the road to sovereign bankruptcy, the more likely it is that governments will exhibit lack of fiscal discipline and "reform fatigue," squandering the proceeds of borrowed hard currency, in the knowledge that, if worse comes to worst, they can obtain a financial pardon. In practice, it is not possible to obtain massive debt forgiveness via quick and painless debt restructurings. The recent tragedy in Argentina, for example, would not have been avoided if the SDRM or the CACs had been in place in 2001. Because a substantial proportion of the Argentine government's debt obligations was held by local banks, pension funds, and insurance companies, any announcement of a payments standstill with the intention to seek meaningful debt forgiveness would surely have triggered a stampede of bank depositors and a collapse of the pension and insurance industries. This would have led to a run on the central bank's official reserves, precipitating a devastating currency devaluation and thus the same economic implosion, political fallout, and popular discontent that were witnessed in late 2001 and early 2002.

In conclusion, bondholders and commercial and investment banks in the U.S. and Europe should be recognized rather than castigated for their track record in dealing with sovereign debt problems. They have helped to resolve expeditiously and even generously the sovereign debt crises in which they have been involved in various parts of the world, especially in recent years. The official development community cannot make a similar claim.

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