Annex

A Note on Insolvency and Sovereign Debt Workouts[1]

1 The issue of insolvency and sovereign debt workout has been addressed in the G-10's May 1996 report, entitled "The Resolution of Sovereign Liquidity Crises". In the case of a sovereign borrower it is difficult to define insolvency, in contrast with the case of a firm. A firm's net worth is, in principle, well defined. A sovereign debtor in financial distress also owns a collection of assets and liabilities. One of the main assets of a state, however, is the capacity to tax. There is no fixed limit to this capacity, so there is no fixed point beyond which a mismatch between assets and liabilities constitutes insolvency. Nevertheless there comes a point beyond which reasonable analysis suggests that the state is unable to pay, even if this analysis is to some extent political. It is desirable to have some substitute for a bankruptcy procedure at national levels to cope with this eventuality.

2 There are essentially four parts to an efficient bankruptcy procedure, each of which needs some analogue in international sovereign debt workouts:

- ❖ protection from an economically inefficient initial 'grab race' by creditors, including a stay on interest payments;
- ❖ the injection of new temporary 'working capital' financing (normally on preferential terms, by providing administrative priority for new creditors);
- ❖ enterprise restructuring and the appointment of new management; and
- ❖ balance sheet (debt) write-down.

3 In a world of complete information and costless negotiations, there would be no need for recourse to any institutional mechanisms to achieve these desired outcomes. Instead, the parties could write down contractually what to do, or how to bargain, in all circumstances. But in the real world circumstances of international capital markets it is extremely difficult to remove debt overhangs; this is because there are no mechanisms for the restructuring of securitised debt and the number of creditors is large and dispersed.

Workouts and the balance sheet write down

4 The G-10's May 1996 Report argues that certain contractual provisions, if broadly incorporated in international debt contracts, could help to facilitate debtholders' decision-making and hence the resolution of a sovereign financial crisis. The proposals that they contemplate involve the following three elements:

a **Collective representation:** By providing holders of international securities with effective mechanisms for communicating with other bond holders and with debtors, collective representation could enable them to proceed with debt restructuring more smoothly and quickly. Macmillan (1995)[2] discusses the required leadership and co-ordination and considers whether there should be one international bondholder council or national bondholder councils. He also considers whether a

1 This material is based on a draft paper prepared for the Commonwealth Secretariat by Richard Portes and David Vines entitled, "Coping with International Capital Flows". The authors are Director and Senior Fellow, respectively, at the Centre for Economic Policy Research, London.

bondholder council should be a representative organisation. The best structure for such an organisation would depend on who would appoint representatives (government, bondholders or some combination) and on what mandate the representatives would employ. This could produce two quite different models of organisation. One would be a quasi-official permanent representative council having significant political power, which could negotiate with the debtor but only with the power to recommend outcomes, not to bind. Alternatively the council would help bondholders to appoint their own representatives with rules governing their election to a negotiating committee. As Macmillan argues, funding for such a council would be important since debt crises can be sudden disasters following long periods of stability; organising funding for an institution with sporadic expenditure needs will be difficult.

b **Qualified majority voting clauses:** Such clauses will enable changes to be made in the terms of a bond contract without the unanimous consent of the holders. This would limit the scope for a small minority of creditors to stall or block the workout process. Eichengreen and Portes (1995)[3] suggest that debt instruments should be appropriately modified to authorise a (qualified) majority of bondholders to reschedule debt issues, as in the case of corporate debt. Market participants argue that this may undercut the creditors' rights too severely. Others note that the London Club steering committees for the rescheduling of commercial bank debt have, in effect, routinely 'imposed' terms on other banks – after lengthy negotiations, the few remaining dissidents have a take-it-or-leave-it (or go to court) choice. Even when they have initiated legal action, the settlements have proceeded.

c **Sharing and similar clauses:** As an addition to (or alternative to) qualified majority voting clauses, sharing clauses could be used as a mechanism to raise the threshold for disruptive bondholder behaviour, as well as oblige debtors to treat creditors in a fair and equitable manner. However, there is little experience with the effects of such clauses when the number of creditors is large and dispersed, as in the case of bonds. Thus, in addition, it could be required that all legal proceedings be consolidated, and that there be a minimum proportional requirement (e.g. 25 per cent) of bondholders needed before a lawsuit was allowed.

5 These proposals go further than those of the G-10. But Portes and Vines argue that they need to go further still in one more important way. Real progress will require that the official sector press the markets to adopt at least the reforms recommended by the G-10 report, rather than expect 'market-led' reforms.

Crisis resolution: the creditor stay, financing and 'new management'

6 As in the case of domestic financial distress, there is a need for a creditor stay, for financing and for 'new management'.

Creditor Stay

7 It is necessary to prevent the 'creditor grab' race which occurs in cases of prospective default. In the sovereign debtor case, the race involves capital outflow. Is it possible to institutionalise mechanisms for dealing with

2 Macmillan, R. (1995), 'Towards a sovereign debt workout system', Northwestern Journal of International Business Law, 16:1, 57-106.
3 Eichengreen, B., and R. Portes (1995), Crisis? What Crisis? Orderly Workouts for Sovereign Debtors, Centre for Economic Policy Research (CEPR), London.

financial distress without the reimposition of capital controls? If not, and if one of the central aspects of liberalisation is the removal of such controls, what then? Might not the mere possibility of debt workout negotiations make the likelihood of capital outflow all the greater?

8 A debtor government can in effect impose a stay, simply by stopping payments. If it does so under force majeure, non-confrontrationally, and with at least tacit IMF approval, creditors are unlikely to penalise it. The G-10 report suggests that the IMF could signal its approval by lending into arrears, and this seems a sensible proposal. The report says such cases should be "rare ...[and] conditioned on very strong adjustment efforts on the part of the debtor country and limited to cases where the debtor country is making reasonable efforts to negotiate with its creditors". This is a realistic approach, provided that the criteria are as stated: the 'rare' cases should not be limited to large countries with political and economic clout.

Financing

9 The new IMF Emerging Financing Facility, to be created by increasing the General Agreements to Borrow, is also relevant here. Although it is intended primarily to deal with short-term liquidity crises, it is also necessary in the case of an overall package which, without financing, might come unstuck due to liquidity problems. If there are to be more negotiations to deal with the longer run issues of debt reduction and restructuring, then there will be more need for liquidity finance to carry debtors over. This is an additional argument for lending into arrears and, hence, for expansion of the resources available to the Fund, i.e. for a substantial quota increase.

'New Management'

10 In corporate bankruptcy, part of the penalty to the management which lessens the risk of moral hazard is the sanction of changing the management. Clearly, this is ruled out for sovereign governments. But the possibility of linking financing with agreement on an IMF-supported adjustment programme provides a safeguard against the moral hazard problem.

A Realistic Way Forward

11 The G-10 sees the adoption of clauses providing for bondholder representation, qualified majority voting, and sharing as a 'market-driven process'. Governments are to recommend such provisions and hope that the markets will respond on their own. It is, however, unrealistic to assume that this will happen. If such changes were so desirable and so easily adopted, the markets would have done so already. There would be no need to recommend action. In fact, there exist significant obstacles to market-driven reform (Eichengreen and Portes, 1996[4]).

12 The G-10's proposals, if adopted, would be a positive step. But they must also be supported by parallel initiatives to enlarge IMF quotas, and endorsement by the IMF's Executive Board of the G-10 proposals regarding lending into arrears.

13 Institutional reform to cope better with future crises will therefore require strong leadership from its supporters and an effective campaign to win over the financial community. Otherwise the next Mexico-type crisis – with no official bailout – could run the risk of seriously undermining the stability of global financial markets and the ability of an increasing number of developing countries to gain further access to these markets.

4 Eichengreen, B., and R. Portes (1996), 'Managing the next Mexico', forthcoming in symposium edited by P. Kenen for International Finance Section, Princeton.

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