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Insolvency and Sovereign Debt Workouts

The second kind of financial problem which a sovereign government may encounter is insolvency. This involves the inability to service debts, because of overborrowing, or because of the worsening of external circumstances in unexpected ways. But sovereign debtors are not strictly analogous to corporate debtors.

8.1 Bankruptcy Proceedings, Moral Hazard and Bailout

Consider what happens when a firm becomes insolvent. A firm is the owner of a collection of assets and liabilities and, if the latter exceed the former, then the firm is technically insolvent: net worth is negative. The debtors are left with a 'debt overhang' – a collection of obligations which they are unable to honour. In these circumstances, one may want recourse to some procedure which would make it possible to remove the debt overhang which prevents debtors making a new start after an unexpectedly poor outturn.

There are three sorts of arguments as to why one might wish to do this. First there is an equity component – it removes the possibility that extreme forms of bondedness will hang over debtors whose assets have gone bad. Second, there is an efficiency component: debt overhangs act as a form of tax on future effort, in that the fruits of any future activity by the debtor belong – in large part or in total – to the creditor. What is the incentive for a debtor to make adjustment efforts, or more generally to make any efforts at all, if a large part or all of the proceeds of that effort belong to the creditor? Third, there is an 'avoidance of bailout' argument. If these arguments against debt overhang are thought powerful, but at the same time the creditors' claims cannot be dismissed, then it may become politically necessary for some third party such as the government to provide the funds with which the creditors can be paid off. A better way to address this issue might be to have a mechanism which sees off the creditors rather than holding the government to ransom by implicit understandings within private contracts.

In the case of the insolvency of a firm there is recourse to bankruptcy proceedings for just these reasons, and for some particularly bad outcomes for the debtor there is relief. In effect, bankruptcy proceedings truncate (or remove) part of the probability distribution of possible returns to the borrower, in that if things go well he/she keeps the reward but if things go badly he/she does not bear all of the cost. Hence the expression 'risk shifting'.

In a world of complete information and costless negotiations, there would be no need for recourse to actual bankruptcy proceedings in order to achieve the desired outcomes. Instead the contracting parties could agree on what to do in all eventualities and write it down contractually (including a 'no hold to ransom' clause). Alternatively the contract could describe how bargaining would take place between creditors and the debtor in the case of a particularly poor outturn. The reasons why, instead of this, there is in fact recourse to bankruptcy proceedings are that (i) there will always be eventualities which cannot be fully foreseen, and (ii) in the absence of a formal bankruptcy process, the costs of bargaining between the debtor and the creditor may be impossibly high.

The risk shifting embodied in bankruptcy procedures does lead to moral hazard. In the knowledge that there is the potential of

recourse to bankruptcy proceedings there is an incentive upon borrowers to take unduly risky decisions, categorised as decisions which – for any given expected average outcome – contain a larger probability of very good and very bad outcomes. If the very good outcome is realised, then the debtor keeps the proceeds, whereas if the very bad outcome occurs, the debtor can expect to be protected by the bankruptcy process and to slough off the bad consequences onto the creditor.

Even though the existence of bankruptcy proceedings does lead to moral hazard, this is not used as an argument that such proceedings should not exist. Rather, a good bankruptcy process must take account of the disadvantages when pursuing the advantages described at the beginning of this section. We may summarise this by saying that an efficient bankruptcy procedure is one that balances two goals: maximising the ex-post value of the firm, and preserving the ex-ante bonding role of debt (the debtor's obligation not to default). Normally it does this by financially reorganising the firm – writing down its debt – but at the same time also by penalising the management in bankruptcy proceedings (e.g. by dismissal) so as to reduce the moral hazard. When considering international workouts for sovereign debt obligations it is important to be aware of both: (i) the desirability of having some equivalent to the recourse to national bankruptcy proceedings; and (ii) the moral hazard to which this might give rise.

Eichengreen and Portes (1995) offered a number of practical reform proposals which would provide for orderly workouts of sovereign debt-servicing difficulties. Some of the proposals in that study have been warmly welcomed by the official community and are embodied in a recent G10 report (Group of Ten, 1996). Nevertheless the response of most market participants has been hostile to such proposals (ibid., p 10), ostensibly because they believe that 'the obligation to repay should be considered almost "'sacred" by the debtor'. One interpretation is that they have implicitly in mind that if the costs of full settlement turn out to be high, third party bailout will be achieved, as it was in the case of Mexico's creditors in late 1994 and early 1995. The official sector's explicit statements that securitized debt will not escape future restructurings are not credible.

Nor are proposals for an international bankruptcy code or court (for the reasons, see Eichengreen and Portes, 1995). Yet as international financial markets become better established and increasingly institutionalised, it is necessary that they evolve institutional arrangements which perform at least some of the same features as national bankruptcy procedures. In particular, it is necessary that there be protection not only for debtors against creditors but also for third parties – namely governments of major nations – against effectively being held to ransom for bailout.

8.2 Sovereign Debt Workouts

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 domestic bankruptcy procedure to cope with this eventuality.

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
- balance sheet (debt) write-down

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, as discussed above, 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, since there are no mechanisms for the restructuring of securitised debts and the number of credits is large and dispersed.

8.2.1 Workouts and the balance sheet write down

The G10 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. This is intended to provide holders of international securities with a mechanism for communicating with other bond holders and with debtors; this would enable them to proceed with debt restructuring more smoothly and quickly. Macmillan (1995) discusses the required leadership and coordination of such a mechanism and considers whether there should be one international bondholder council or national bondholder councils. He also considers whether a bondholder council should be a representative organisation. The best structure for such an organisation would depend on who would appoint representations to it (governments, bondholders or some combination) and their mandates. 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 bond holders 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. He recommends funding by some kind of small fees (effectively a kind of "top-slicing" tax) at the time of issue. Given the sums involved, and the rather limited need for financing, the rate of such a levy would need to be extremely small indeed.

(b) Qualified Majority Voting Clauses. Eichengreen and Portes (1995) suggest that debt instruments should authorise a (qualified) majority of bondholders to reschedule debt issues, as in the case of corporate debt. Such clauses would enable changes to be made in the terms of a bond contract without the unanimous consent of bondholders. This would limit the scope for a small minority of bondholders to stall or block the workout process. 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 creditors 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.

These proposals go further than those of the G10. But 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 G10 report, rather than expecting 'market-led' reforms.

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

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

(i) Creditor Stay

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 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?

A debtor government can in effect impose a stay, simply by stopping payments. If it does so under force majeure, non-confrontationally, and with at least tacit IMF approval, creditors are unlikely to penalise it. The G10 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 or with special ties to major economies.

(ii) Financing

The new IMF emergency financing facility discussed above, to be created by increasing the General Agreements to Borrow, is also relevant here. Although it is intended to deal with short-term liquidity crises, it is also necessary in the case of an overall debt-workout 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.

(iii) 'New Management'

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 support for a debt workout with agreement on an IMF-supported adjustment programme provides a safeguard against the moral hazard problem.

8.3 A Realistic Way Forward

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 but simply to hope that the markets

will see the light. This hope is as unrealistic as the academic proposals for an international bankruptcy court: in this case, if such changes were so desirable and so easily adopted, the markets would have made them already. There would be no need to recommend action. In fact, there are significant obstacles to market-driven reform (see Eichengreen and Portes, 1996).

The G-10's proposals, if adopted, would be a positive step. But the advanced industrial countries and the developing countries in strong financial positions must push for the G-10 proposals and must support parallel initiatives to enlarge IMF quotas. Moreover, the Executive Board of the IMF should endorse without delay the G10 proposals regarding lending into arrears and should not hesitate to apply them where appropriate.

The Clinton Administration is likely to support expanded financial resources for the IMF, since the United States is the leading source of portfolio capital to emerging markets and the country which underwrote the largest share of the Mexican bailout. It has some support in the Fund, which could find these proposals enhancing its role in dealing with sovereign liquidity crises.

But other high-income countries may not agree. The German authorities are preoccupied by moral hazard and worry that any reforms will encourage reckless lending and overborrowing. The Japanese, their experience with bank insolvencies firmly in mind, feel much the same way. The French and Italians worry that an agreement to rewrite international debt contracts will force them to do so for their parastatals. The most prosperous and financially secure developing countries, not consulted by the G-10, may be suspicious of innovations that acknowledge the possibility, however slight, that debts might one day have to be restructured. Thus, as was the case during the Mexican meltdown in 1995, it will be difficult for the international community to achieve consensus.

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 to the required reforms. Otherwise there is a real possibility of another Mexico-type crisis, but this time with a different denouement. With no bailout from the official sector, a sudden exodus of capital from any major debtor country will not only be very damaging to the country concerned, but could also undermine the stability of global financial markets. Creditors could be very badly hurt; we think that they could well be unexpectedly badly hurt – and debtors as well. Better, in our view, to take pre-emptive action.

There is another reason for seeking leadership now for moderate reform initiatives. If such a crisis were to occur, it is perversely possible that private market participants might then voluntarily push for very strong reforms indeed. It is entirely plausible that the changes sought by some market participants (and officials) might then be much more interventionist than the modest ones proposed in the G10 Report or in this paper, so much so as to damage international financial markets by inappropriate or over heavy regulation, or indeed so strong as to lead to cartelisation or monopolisation of international financial markets. Paradoxically, there might then be a need for leadership to head off overzealous "reform" proposals.