



The International Architecture for Resolving Debt Involving Private-Sector Creditors: Recent Developments, Challenges, and Reform Options

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Introduction

- IMF staff paper prepared at request of G20 IFA WG
- Sovereign debt is the only debt class without a bankruptcy mechanism. The international community has relied on the contractual approach to resolve sovereign debt crises involving private creditors.
- Paper focuses on recent developments including experience with sovereign debt restructurings involving private-sector creditors, challenges, and reform options.
- Paper does not cover official sector involvement or the coordination between official-sector and private-sector sovereign debt restructurings.

Evolution of the Sovereign Debt Landscape – Collective Action Clauses

- On balance, the experience to date, while not extensive, suggests that the framework for sovereign debt restructuring involving private creditors remains generally appropriate.
- Almost all international sovereign bonds include some form of CACs. Approximately 91 percent of new international sovereign bond issuances since October 2014 contain enhanced CACs.
- Compared to earlier periods, sovereign debt restructurings have more often been preemptive, much shorter in duration and have obtained higher creditor participation on average.
- Full participation in half of the cases and no ex-post litigation with private creditors, when CACs were used. Creditor coordination challenges have been managed.
- Enhanced CACs have now been used for the first time, in the recent restructurings of Argentina and Ecuador.
- Euro-area members recently agreed to incorporate a euro-area version of enhanced CACs into all Euro-area sovereign bonds as of January 1, 2022.

Evolution of the Sovereign Debt Landscape – Other Developments

- Use of State-Contingent Features in new bond contracts to incentivize creditor participation and to protect from future downside risks:
 - ▶ Hurricane and natural disaster clauses in Grenada and Barbados.
- UK, France, and Belgium have adopted “anti-vulture fund” legislation, designed to discourage holdout creditors, though the laws adopted vary in scope and intent.

Challenges to the Current Framework

- Approximately only 50 percent of all outstanding debt stock contain enhanced CACs.
- Non-bonded debt often lacks majority restructuring provisions for payment terms, and there has been an increase in the complexity and diversity of debt instruments include the use of collateralized debt. Sovereign debt restructurings in a few low-income countries were protracted, incomplete and non-transparent.
- Sub-sovereign debt has increased in volume and often lacks CACs or majority restructuring provisions for payment terms. SOEs may not be subject to an insolvency regime.
- Other claims against sovereigns, such as arbitral awards, can be significant.
- There is a lack of debt transparency, information asymmetry, and a lack of clarity on the perimeter of “private” claims versus “official” claims.



Possible Reform Options: legal framework

- The IMF will continue to promote the inclusion of enhanced CACs in international bonds (sub-sovereign should also be encouraged to use these clauses)
- Sovereign should be encouraged to issue debt under trust structures; sub-sovereign entities should also be encouraged to include enhanced CACs in foreign law bonds
- The official and private sector should cooperate to develop model majority restructuring provisions for payment terms for syndicated loans.
- The official and private sector could also cooperate related to collateral including strengthening negative pledge clauses to disincentivize collateralization.
- While not a reform option, the desirability of adopting/expanding “anti-vulture fund” legislation could be further explored.



Possible Reform Options: official sector policies

- Encourage increased use of state-contingent debt (e.g. natural disaster clauses)
 - ▶ Joint issuance?
 - ▶ Acceptance by official bilateral lenders?
- Scheduled review of IMF lending policies
 - ▶ Pre-default: conditions under which IMF can lend in unsustainable cases creates incentives for debtors and creditors to restructure speedily
 - ▶ Post-default: lending into private and official arrears, respectively (LIA/LIOA).
- Encourage greater debt transparency.
 - ▶ Ongoing review of IMF debt disclosure requirement in program contexts
- Develop debtor countries' debt management capacity

Responses to a Systemic Debt Crisis: What if the Current Architecture is Insufficient?

- Since contractual improvements take time to affect the debt stock, additional instruments if needed could only be of a statutory or financial nature.
- Specific measures (not ***recommended*** by IMF staff, but discussed in paper):

Statutory instruments

- Domestic law (e.g. “anti-vulture” legislation) or international law options (e.g. UN security council resolution) that limit creditor recovery or the timing of lawsuits or immunize assets for judicial actions:
 - ▶ reduces incentives to hold out and limits the ability of holdouts to derail an ongoing restructuring
 - ▶ but raises significant legal and policy issues; would require careful consideration, and only as a last resort/on a time-bound basis.

Financial instruments

- IFI-financed cash or credit enhancements (buybacks, cash sweeteners, collateral)

IFI-financed “sweeteners”: rationale and limitations

Rationale

- In an environment of high uncertainty, there could be a large gap between debt relief from a debtor perspective (discounted at “normal” interest rates) and losses from a private creditor perspective (“haircuts”, discounted at prevailing market rates).
- Offering instruments that are either relatively short term or partly collateralized can close that gap, enabling deeper debt relief for a given haircut.
- This requires upfront finance, which could be provided by IFIs. Efficient as long as risk taken by IFIs is lower than the (perceived) risk taken by private creditors.
- Precedent: Brady deals. Helped resolve the last systemic debt crisis.

Limitations

- Self-defeating if scale is too large: could undermine IFI’s preferred creditor status (and hence one of the conditions ensuring the IFI’s risk premium remains contained).

Conclusion

1. Significant progress has been made ...

- ▶ Adoption of enhanced CACs (~50% of international debt stock); some issuance of state-contingent debt; restructurings more preemptive, faster, higher participation

2. ... but the system faces new challenges

- ▶ More fragmented creditor base, non-bonded debt, collateralized loans, increased share of sub-sovereign public debt.

3. Meeting these challenges will require reform.

- ▶ Continue improving bond contracts, majority provisions in loans, debt transparency, debt management, review of IMF lending policies

4. In a systemic crisis, additional statutory and financial tools could be mobilized

- ▶ but these carry legal and policy risks and should be used only as a last resort.