

IMF Board Holds Informal Seminar on Sovereign Debt Restructuring

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On March 6 and March 8, 2002, the Executive Board held an informal seminar to discuss approaches to improving the legal framework for sovereign debt restructuring.

Background

In the rare cases when countries run up unsustainable debt burdens, they need to seek a restructuring of their obligations. An important short-coming in the international financial system is the absence of a framework for the predictable and orderly restructuring of sovereign debts. There is no comprehensive mechanism for private creditor majority decision making—a problem that tends to be compounded when the debt is comprised of numerous different debt instruments issued in different jurisdictions. The upshot of this collective action problem is that debt restructuring is often delayed, prolonged, and disorderly, depleting asset values of creditors and imposing severe hardship on the debtor country. This is damaging not only to the debtor and its creditors, but it is also disruptive to international capital markets and to the trading partners of the debtor country.

The Executive Board has discussed two staff papers on ways to improve the framework for debt restructuring. The first in November 2001¹ followed closely the speech by First Deputy Managing Director Anne Krueger² setting out a possible new statutory regime governing debt restructuring. The second staff paper in February 2002³ elaborated further on such statutory approaches, and developed an approach in which the Fund played a less central role in decision making. The second paper also assessed the extent to which the use of collective action clauses in debt instruments could achieve the desired improvements in the sovereign debt restructuring process. The First Deputy Managing Director's statement for the seminar summarizes briefly the various approaches⁴. There are pros and cons to all the options being considered, and it is recognized that substantial further consideration is necessary before coming to concrete proposals.

Executive Board Assessment

At the conclusion of the seminar, First Deputy Managing Director Anne Krueger made the following remarks:

"I thank Directors for a very thoughtful discussion of the case for a new approach to sovereign debt restructurings, providing the opportunity for a preliminary consideration of the broad outlines of three possible approaches to improving the framework for sovereign debt restructuring. The views expressed by Directors on a wide range of relevant issues will help to shape the directions for the period ahead and provide useful guidance to the staff for future work.

"The seminar highlighted a common belief among many Directors, a belief shared by Management, that the existing process for restructuring sovereign debt is more prolonged, more damaging to the country and its creditors, and more unpredictable than is desirable. Both countries and their creditors would gain if stronger incentives were created for countries with unsustainable debts to address their problems rapidly, and if there were a more predictable process, in such exceptional cases, for reaching rapid agreement on a restructuring that paves the way toward the restoration of sustainability. This needs to be done without introducing incentives that might result in unnecessary defaults or broadly increasing the perceived risk of default.

"Going forward, our challenges are to develop an improved framework, which could facilitate the sovereign debt restructuring process, and to improve our analytical basis for making judgments about debt sustainability. As many Directors noted, these efforts should be integrated into broader efforts to improve the effectiveness of crisis prevention and resolution. Recourse to a comprehensive debt restructuring would remain appropriate in only very limited and exceptional circumstances, consistent with the private sector involvement (PSI) framework.

"There is broad agreement that the absence of a mechanism for securing majority action among a diverse set of creditors during a sovereign debt restructuring is an important short-coming of the current system. Provisions for majority action would be most effective if supported by three other features, all of which protect the debtor's assets and capacity to pay while working toward a sustainable outcome. These comprise: a stay on litigation following a payments suspension; protection of creditor interests during the stay; and the provision of senior new financing by private creditors.

"The staff paper for our discussion outlines three broad approaches for achieving these objectives: a statutory approach with enhanced Fund authority, a statutory approach based on majority action across the aggregated debts of the sovereign, and a contractual approach. The second option reflects an intermediate approach and would place all key decision making powers in the hands of the debtor and a qualified majority of its creditors. Although an amendment of the Fund's Articles of Agreement could provide the statutory basis for this power, the Fund would not be empowered to make decisions that limit the enforcement of creditor rights. Rather, it would give the qualified majority of creditors the ability to accord the debtor temporary protection against legal action, strengthen the hand of the debtor and a qualified majority of its creditors against a dissident group of creditors and perhaps most crucially, allow the entire creditor body to vote as a whole rather than instrument-by-instrument (which is the case with existing collective action clauses). At the same time, safeguards would be established to protect

the seniority of certain claims, and procedures would need to be put in place to verify claims and ensure the integrity of the voting process.

"Many Directors believed that such intermediate options could help address concerns about significantly extending the Fund's powers in a statutory approach, although it was recognized that the difficulties to be overcome for the effective adoption and implementation of such an approach would still be significant. Some Directors, however, expressed a strong preference for a contractual approach not requiring an Amendment of the Fund's Articles, and cautioned against any mechanism that would imply the creation of an international judicial body to oversee the restructuring process, either within or outside the Fund. Some other Directors saw considerable merit in a statutory approach that would grant the Fund additional legal authority to make key decisions in the operation of the restructuring mechanism, including in endorsing the activation of a stay on legal action. In this vein, several Directors cautioned against requiring the approval by a qualified majority of creditors of the activation of the stay, and suggested that a decision on activation by the debtor in consultation with the Fund would be more practical and effective.

"It is too early to decide now on a single approach, and, as many Directors noted, the contractual approach based on collective action clauses could be complementary to a statutory approach. At the same time, a few Directors noted that, considering that a broad-based agreement among the membership would be important, the statutory and the contractual approaches could also be viewed as alternatives. The staff will continue to work through the issues that would need to be addressed to make a statutory approach operational, as well as the policy and other changes that would be needed to operationalize the contractual approach. This work should rely on a careful assessment of the potential benefits and costs among alternative approaches vis-à-vis the current process of debt restructuring.

"In moving forward on the many complex issues involved, it will also be important that we end up with an approach that creates broad debtor and creditor ownership of the process. Among the issues that would need to be addressed is the scope of the debt to be covered in the operation of such a statutory mechanism, and, in this context, we noted the strong reservations that a number of Directors expressed against including domestic public debt and external debt of the private sector. In particular, the appropriate treatment of domestic debt instruments, especially in cases where these represent a high portion of the sovereign debt, will need careful further examination. The staff note sets out a number of other issues relevant to the design of a sovereign debt restructuring mechanism (SDRM) that will be explored in light of today's discussion. These include: the treatment of nonsovereign debt and, in that context, the role of exchange controls, including the applicability of Article VIII, 2(b) of the Fund's Articles; the provision of senior private financing which raises also questions about the relative standing of senior private financing and financing from preferred creditors; the protection of creditor interests during the stay; dispute resolution mechanisms; and the implications of an SDRM for the HIPC process.

"It will inevitably take time to sort through the complex issues associated with the design of an SDRM, and then, if so agreed and if there is broad-based support for the steps that it would require, to put a statutory approach in place. Contractual improvements could help before then, and, as was emphasized by several Directors, such improvements should be pursued vigorously on their own merits. We will continue to explore ways in which contractual approaches to debt restructuring can be made more effective. Future work in this area will include steps that could be taken to create stronger incentives for the use of appropriate majority restructuring and majority enforcement provisions in international debt contracts. It will also include an assessment of the feasibility and market acceptability of collective action clauses that aggregate claims across instruments for voting purposes.

"Finally, efforts to improve the existing framework for debt restructuring should not displace other aspects of our work program on the resolution of financial crises. Improving our assessment of debt sustainability is crucial. Today's discussion also confirmed that an early review of access limits in capital account cases will be a key element in our efforts to improve the effectiveness of the PSI framework. We will turn to these two issues in the coming weeks and months respectively, and the Board will have an opportunity to take stock when discussing the Managing Director's report to the International Monetary and Financial Committee on the direction of our work in all these areas," Ms. Krueger stated.

¹ ["A New Approach to Sovereign Debt Restructuring - Preliminary Considerations"](#)

² ["A New Approach to Sovereign Debt Restructuring"](#), Address by Anne Krueger, First Deputy Managing Director International Monetary Fund, given at the National Economists' Club Annual Members' Dinner, American Enterprise Institute, November 26, 2001

³ ["Sovereign Debt Restructuring Mechanism - Further Reflections and Future Work"](#). A background paper ["Sovereign Debt Restructurings and the Domestic Economy - Experience in Four Recent Cases"](#) has also been posted on the IMF's website.

⁴ ["Statement by the First Deputy Managing Director on Sovereign Debt Restructuring Mechanisms"](#), Executive Board Meeting March 6, 2002