Against All Debts? Solutions for Future Sovereign Defaults

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Fragile Global Debt Situation

Sovereign debts and debt crises have been a major topic for international policy-makers for quite some time. This policy issue came to the fore with the debt crisis in Latin America in the 1980s; it was reinforced during the Asian crisis in the late 1990s and put on the official agenda after some spectacular sovereign defaults, such as the Argentina crisis at the beginning of the twenty-first century. In the wake of the Argentina crisis there was considerable pressure to install some kind of formal mechanism for dealing with sovereign defaults. But corresponding regulatory innovations remained weak due to opposition from the US administration, powerful financial market actors, and emerging market representatives.

Today, the global credit system is again in a state of instability, although the situation is somewhat different from the circumstances ten years ago. Current instability is mainly associated with the credit crisis following the »subprime shockwave« on the US housing market. Other critical factors are large global imbalances between capital exporters and importers and possible spillover effects of the credit crunch on emerging markets, in particular because emerging markets are to some extent facing different financing situations (IMF 2007): some emerging market countries have been able to cut back external sovereign debt as a consequence of rising oil revenues, while others have increasingly converted external debt into domestic debt denominated in local currency, making them less vulnerable to external shocks. In any case, neither strategy is »bulletproof« and sovereign debt crises – not only, but above all in emerging markets – are still possible.

While this is well known, there is still no international consensus on how to establish an orderly and transparent restructuring mechanism. But systemic proneness to debt crises shows that a solution is urgently required. The difficult question is: when sovereign debt restructuring becomes necessary and unavoidable, what regime would provide orderly restructuring, while safeguarding the balance of rights of both the creditor and the debtor (Roubini 2002)?

In this article, we try to identify an ideal-type solution by comparing and evaluating the most comprehensive proposals currently being discussed. First, we analyse the problems of collective action which typically occur in the event of a default. We then review concepts of how to handle debt crises at international level. In a first step, we provide an overview of the main proposals for solving such crises. The failure of the IMF's Sovereign Debt Restructuring Mechanism (SDRM) proposal to establish a legally binding framework is explained, as are the shortcomings of the current Collective Action Clauses (CACs). The main part, however, is dedicated to the evaluation of two proposals from non-governmental organizations (NGOs) and think-tanks: the *Fair and Transparent Arbitration Process* (FTAP), which puts forward an international insolvency procedure analogous to US Bankruptcy Code Chapter 9, and the *International Debt Framework* (IDF), a framework associated primarily with the *Group of 20* (G20).[1] They both claim to address the shortcomings of the current system and we evaluate them in terms of whether they establish an appropriate regime for dealing with future sovereign defaults. While the FTAP has been developed over a number of years with many contributions by NGOs and researchers, the IDF is not based on the existing approach but establishes a new framework strongly based on G20 participation. This sends a clear signal that a power shift is desired in the international financial institutions towards the G20, consisting of developed countries and emerging market economies. But the question is whether the IDF would really constitute a better solution than the FTAP. We try to identify the best possible solution, before concluding with some remarks on the political chances of such a concept in the current »window of opportunity.«

Collective Action Problems in a Sovereign Default

A number of typical collective action problems arise in the event of a sovereign default:

1. The G20 is an informal forum promoting dialogue between finance ministers and central bank governors from systemically significant industrial and emerging market economies. See: http://www.g20.org/

- bond financing poses the specific problem of creditor coordination since the creditor base is highly decentralized (there are many individual bond holders across the world) and anonymous;
- counterproductive strategies on the part of single investors in the event of debt restructuring due to the individual rationality of free riding;
- in crisis-prone times investors tend to withdraw their capital as quickly as possible, sometimes making things worse;
- individual investors tend to sue the debtor for not servicing his debt; in a macro-perspective this can also be counterproductive.

Shift from Syndicated Bank Loans to Traded Bonds

To understand why creditor coordination has become so difficult, one has to consider the changes in lending practices caused by international capital flows: the shift from syndicated bank loans to traded bonds as the principal vehicle for the extension of financial credits to sovereigns. A syndicated loan is a large loan in which a group of banks work together to provide funds for a borrower. A bond is a debt asset in respect of which the debtor promises to repay the lender the amount borrowed plus interest over a period of time (Scott/Wellons 2002: 163). This shift was desirable as it improved the efficiency of international capital markets and allowed sovereigns to extend their financial credits. But since it has broadened the investor base for financing emerging market sovereigns, it has also spread the risk to a higher number of creditors (Krueger 2002b: 6). With many bondholders now involved, private creditors have become increasingly numerous, anonymous, and difficult to coordinate (IMF 2001).

Holdout or Free-Rider Problem

Difficulties of collective action are the primary source of the potential market failure that could hinder successful sovereign restructuring. A collective action problem emerges when individual and group strategies differ. In the context of restructuring, this dilemma is demonstrated by the »holdout problem.« The main restructuring technique for sovereign bonds is the »exchange offer« reflecting a restructuring plan. The offer involves an exchange of existing bonds for new ones bearing longer maturities, and at interest rates that are not lower than the original interest rates (Cline 2002: 5). While it is in the interest of the group as a whole to participate, it is not in any individual's interest to do so. An individual bondholder may prefer to »free-ride« and reject the exchange offer, hoping that he will ultimately be repaid in line with his original contracts. This selfish approach harms the group as a whole because it delays restructuring and ultimately reduces the resources of the debtor country for the purpose of repaying its debts.

For this reason, sovereigns can face substantial difficulty getting creditors collectively to agree to a restructuring plan. The problem of imperfect information increases the risk of free riders even further. Any individual creditor is likely to have imperfect information about the actions and intentions of its fellow creditors (IMF 2001). This makes creditors feel insecure since they fear that too many creditors will go this way instead of joining the restructuring process.

The Rush-to-the-Exit Problem

Another dimension of the collective action problem becomes evident in the run up to a crisis. If creditors fear a financial crisis, they may try to »rush-to-the-exit« by withdrawing their money immediately (Roubini 2002a: 17, 23). From the perspective of an individual creditor this would be rational, as he could secure a better price for his claims in comparison to other bondholders who approach the financially distressed sovereign debtor at a later stage (Berensmann/Schroeder 2006: 3–4). For the group this decision is harmful as the assets of the other creditors might face significant value losses. This loss in value makes it difficult to issue new bonds or induces creditors to raise their risk premiums, which in turn means rising interest rates for the country affected. Rising costs may adversely affect the financial situation of debtors, triggering a financial crisis.

The Rush-to-the-Courthouse Problem

While a unilateral debt standstill may take care of the inefficiencies of a »rush to the exit,« it may cause a rush to the courthouse. Instead of accepting the exchange offer, a creditor could start litigation (»rush to the courthouse«), seeking full payment of bond and pre-judgment attachment. Since an insolvent debtor lacks sufficient assets the collective action problem emerges: the first creditor to go to court gets the asset, leaving the debtor with fewer assets to offer its remaining creditors. As soon as the first sign of insolvency appears, the risk of litigation from a wide range of creditors is at hand (Roubini/Setser 2004: 295, 296).

These problems clarify the difficulties a sovereign faces if it decides to try to negotiate debt restructuring with its creditors. As already demonstrated, the rational behavior of individual members of the diffuse and diversified creditor community may hinder restructuring.

Competing Concepts of Debt Restructuring

There are a number of competing concepts for tackling collective action problems in a default situation currently resting on the shelves of commercial banks, the IMF, the OECD, NGOs, and diverse finance ministries and central banks, all waiting for the next debt crisis to break out. After the Argentina default the IMF launched an initiative labelled the »Sovereign Debt Restructuring Mechanism« (SDRM), though it lost the political battle against powerful (particularistic) interests of market actors deeply institutionalized in the US Treasury and emerging-market elites. Paradoxically, both groups – market actors, which are the main creditors, and emerging markets, which are the main debtors – were supposed to benefit from such a mechanism. However, the status quo of an anarchic system of market failure with a comfortable bail-out-mechanism in the form of the IMF proved more attractive than a new universal regulation. Today, therefore, there is no formal mechanism for addressing sovereign debt crises and breaking the vicious circle of procyclical incentives for creditors and debtors (Kellermann 2006: Chapter 5).

The Sovereign Debt Restructuring Mechanism was only one proposal for a more orderly restructuring of sovereign debt. In order to counter the SDRM, the business community launched the idea of Collective Action Clauses (CACs) which proved to be highly successful, contributing to the SDRM's demise four years ago. Proposals from the community of the Non-Governmental Organizations were more far-reaching in terms of scope of regulatory approach. Accordingly, they had difficulties in articulating their idea of a debt restructuring mechanism and in the end played a minor role in the debate. In the following section, we look more closely at the competing concepts.

Sovereign Debt Restructuring Mechanism (SDRM) and Collective Action Clauses (CACs)

The SDRM was first tabled at the end of 2001 by Anne Krueger, then First Deputy Managing Director of the IMF. The original version incorporated a number of ideas developed by heterodox scientists associated with the NGO community (Krueger 2001). But during the ensuing arbitration process in 2002 and the beginning of 2003, the crucial features were again eliminated from the concept. One such far-reaching novelty was private-sector involvement in crisis resolution by creating an independent and international debt arbiter to decide on burden-sharing in the case of a default. To have an effective and fair arbitration process a standstill on the debt service and a stay on litigation was foreseen in the initial SDRM version – a »bombshell,« according to the financial community (Rieffel 2003: 250). The IMF's aim was to reduce discretionary access to the fund on the part of market interests in times of crisis and to restore its lost legitimacy, arising from its problematic role as an international lender of last resort. The IMF sought to introduce a new statutory framework for a universal debt workout mechanism which would have applied to all types of sovereign debt. The failure of SDRM at the Spring Meeting of the IMF and the World Bank in 2003 was mainly a consequence of three factors: (i) against all theory and rationality the business community was able to convince important debtor governments of rising borrowing costs in case of SDRM's success; (ii) the IMF's role as a »bankruptcy court« or arbiter was not designed neutrally – it would have played a conflicting role as both arbiter and creditor, which provided an opening for opponents; and (iii) as already mentioned, market actors launched a counter-proposal in the form of Collective Action Clauses (CACs) (Kellermann 2006: 259–64).

The CAC approach appeared to be an elegant solution, since they were designed to solve collective action problems of single bond issues. But the IMF rejected CACs as an alternative to the SDRM and modified its approach by deleting the standstill and stay-on-litigation clause.

But CACs have several shortcomings. First, they do not address the massive stock of pre-existing debts, the main source of the insolvency problem. As debt is issued in several jurisdictions, there are risks of non-uniformity of treatment and difficulties of cross-jurisdictional coordination (Round 2003: 7). In fact, they do not solve the problem of bondholders acting as free riders because there is no mechanism to force them to agree to the changes. Private lenders are presently not including them voluntarily in their new debt contracts (Dodd 2002: 4). Thus, CACs are not sufficient to address the main problems of sovereign debt restructuring.

The two concepts we discuss in sections 3.2 and 3.3 have not yet entered the political debate, as they are even more far-reaching than the initial SDRM version. But since a universal mechanism is still absent from the international agenda, they have the potential to exert some influence in the future.

Fair and Transparent Arbitration Process (FTAP)

The non-statutory approach is analogous to the principles of US municipal insolvency, US Code Chapter 9.[2] It is suggested that risk and liability must be reintroduced into international credit relations to allow markets to function (Raffer 2007). Accordingly, the current system shifts the risk onto debtors which encourages moral hazard on the part of creditors – they keep on lending money without checking the debtor's liquidity.

The rule of law requires that one must not be a judge in one's own cause; this entails that a neutral institution take the final decision. In contrast to Chapter 9 that provides for a standing court, the FTAP proposes an ad hoc arbitration panel. Arbitration is a type of dispute settlement whereby conflicting parties bring their conflict before a tribunal, which decides on the issue and makes a final ruling. Both creditors and debtor nominate one or two persons, who in turn elect one more person to achieve an odd number. At the beginning of any arbitration, the conflicting parties agree on a framework of rules (Raffer 2005a: 365).

The FTAP strongly emphasizes the debtor's sovereignty. Only the debtor makes decisions on declaring bankruptcy analogous to USC §§901, 301.[3] The court may not interfere without the debtor's consent with its political or governmental powers (USC §904). The principle of debtor protection demands that the money for servicing a country's debt must not be raised at the expense of its economic future. The debtor is allowed to maintain basic social services essential to the health, safety, and welfare of its inhabitants.

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2. See: Raffer/Singer 1993: 194; Raffer 1993, 2005a, 2005b; Fritz/Hersel 2002; Pettifor 2002; Round 2003.
3. The text of the US Code is accessible at: http://www.law.cornell.edu/uscode/html/uscode11/usc_sup_01_11_10_9_20_I.html

In order to be protected from its creditors the sovereign can petition for a standstill (USC §921) which operates as a stay of claim enforcements against the debtor (USC §922). Arbitrators have the task of mediating between debtors and creditors. Analogous to §943 USC, civil society representatives have the right to be heard. Arbitrators decide only if and when debtors and creditors cannot reach an agreement or if representative organizations show that an agreement would impose too heavy a burden on the population. Agreements between debtor and creditors require the panel's confirmation.

Debt relief has to be negotiated within the arbitration panel. Irrevocable and/or so-called odious debt must be excluded from the amount of debt to be restructured.[4] Financing has to be made available (probably by the IMF) to keep the debtor's economy viable. Inter-creditor equity requires that IFIs, and especially the IMF, must be financially responsible for their advice and must bear the risk of losses.

The final award of the arbitration panel is binding for all parties. Moreover, a sanction mechanism is scheduled. If any of the parties believes that the award has been violated, it can call upon the arbitration panel. If the panel finds a violation on the part of the debtor, the former decision on the legitimacy of claims remains untouched but the panel can revise its original judgment about debt relief. If the creditor side does not adhere to the judgment, it can serve as legal basis for proceedings at a national court (cf. Fritz/Hersel 2002).

International Debt Framework (IDF)

The main objective behind IDFs is the creation of an environment in which the debtor government on the incidence of sovereign default can negotiate in good faith with all its creditors. Taking as its point of departure an understanding that the current system has shortcomings and risks that must be regulated more fairly and predictably, the approach concentrates on crisis prevention *and* crisis resolution (Berensmann/Schroeder 2006). To ensure the predictability of the debtor's financial situation and the restructuring process for international creditors, a code of conduct (now: *Principles*) developed by the *Institute of International Finance* (IIF)

4. »Odious debt« is sovereign debt incurred by a government lacking popular consent, utilized for no legitimate public purpose. Shafter 2005: 49.

is used.[5] The *Principles* constitute a set of voluntary market-based guidelines for cooperative action and focus on four areas: (i) Transparency and Timely Flow of Information, (ii) Close Debtor–Creditor Dialogue and Cooperation to Avoid Restructuring, (iii) Good Faith Actions, and (iv) Fair Treatment. The IDF integrates the non-binding *Principles* into the institutional framework of a restructuring mechanism, thereby constituting a middle ground between a legally binding insolvency procedure and a voluntary code of conduct.

As a permanent institution with the task of crisis prevention an *IDF Secretariat* (IDFS), comprising a small group of experts on debt and economic development, would be closely associated with the *Group of 20* (G20). To ensure adequate representation of debtors and creditors, all stakeholders (debtor, creditor countries, private creditors, IFIs and the G20) nominate candidates for the Secretariat. Its main task would be the preparation and analysis of information on emerging countries' debt markets and of risk assessments. It would also serve as a forum for regular dialogue between debtors, creditors, and financial-market experts and provide an information exchange channel, lowering market uncertainties and enhancing transparency.

For crisis resolution, an *IDF Commission* (IDFC) would be established as an ad hoc mediation body. Besides assuring good-faith negotiations, this body would guarantee fair treatment (for example, inter-creditor equity). On this model, the debtor initiates the restructuring mechanism if its debt is unsustainable. Then the IDFC is created, comprising representatives of the debtor, private creditors, multilateral lenders, and sovereign creditors. It determines the value of external claims. IDFS members assist in the selection of mediators who serve as external advisors in the negotiation process. If a qualified majority of G20 member states agrees, the IDFC gives the sovereign debtor the right to seek a 90-day suspension of debt servicing. A stay on litigation is bound to certain conditions. The outcome of the ensuing mediation process lays down the amount of necessary financial support, an economic adjustment path to promote long-term debt sustainability, and (if necessary) the level of debt relief.

5. IIF, Principles for stable capital flows and fair debt restructuring in emerging markets (2005). The IIF is a global association of financial institutions such as large commercial banks and investment banks, insurance companies and investment management firms with the aim of supporting the financial industry, see: http://www.iif.com/about

Generally, the principle of equal treatment of all creditors requires that all types of external debts (multilateral, bilateral, and private) are included in the restructuring process. Considering the special importance of the flow of trade as stabilizer of the country's economy, debtor and creditors ensure that trade credits are fully serviced and preserved during the restructuring process. Trade credits are short-term finance obtained by buying goods and services that do not require immediate payment. While generally not enjoying a privileged status, the role of the IMF in providing new financing in times of crisis must be considered. It may acquire preferred status regarding these loans on condition that IMF conditionalities be subject to the restructuring negotiations.

An Ideal-type Solution?

In this section, on the basis of comparison and evaluation, we shall try to identify the strengths and weaknesses of the various proposals. The different interests involved made implementation of the SDRM highly unlikely and sure enough the proposal failed. FTAP and IDF representatives claim that they want to address the shortcomings of the current system. But what makes a proposal a »better« solution? We shall attempt to measure this in terms of a number of criteria. The proposals have to be inclusive, engaging a broad range of stakeholders, and equitable, in the sense of more equitable burden-sharing of the monetary costs between debtors and creditors – as defined under the so-called *Monterrey Consensus* (UN 2002). Furthermore, the proposals must offer an effective solution for the collective action problem.

Regarding the criterion of inclusiveness we shall examine the proposals focusing on institutional representation. The IDF would be established within the G20. The inclusiveness of the G20 as the global forum for dealing with unsustainable debt is questionable. While there are no formal criteria for G20 membership, members are countries of systemic significance for the international financial system. Hence, a significant proportion of countries are not represented. The IDF Secretariat is designed above all for G20 members, in terms of both composition and tasks. The IDF Commission also assumes the involvement of G20 member states (for example, agreement on stay on enforcement). Non-G20 members can also make use of the crisis resolution mechanism, but the design of the crisis resolution body would shift the main decision-making power to the G20. Within the FTAP, all states would have access to the mechanism and would be treated equally. Regarding debtor and creditors it foresees involvement to the same degree. It applies US Code Chapter 9 which gives other affected entities (in this case, civil society) a right to be heard. The FTAP develops a mechanism that ensures the involvement of as many stakeholders as possible.

An indicator of the level of equitable burden-sharing embodied in the proposals is the issue of debt relief. The IDF proposal does not go into detail on this issue. If necessary, the IDF Commission would define the level of debt relief required for long-term sustainability. The current lack of a more concrete mechanism is a weakness of the concept. The FTAP foresees the cancellation of all debts that are uncollectible, including so-called »phantom debts,« which are technically irrecoverable (Raffer 2005b: 10). Odious debts are also not included in debt negotiations. The FTAP thus shifts the risk of lending to those creditors that do not properly check the debtor's liquidity or the purpose of the debt. A more equitable distribution of the monetary costs of indebtedness would also be achieved.

Regarding the concepts' effectiveness, there are also major differences. The IDF proposes mediation, the FTAP arbitration. Mediation is normally a satisfactory solution since the agreement offers a high degree of compliance and ownership. But it has its limits since it can only be as effective as the parties wish it to be (cf. Carter/Trimble/Bradley 2003). If one of the parties or a number of creditors ultimately do not agree, or decide not to implement the final decision, no mechanism beyond mediation is provided to solve the critical situation. This is especially problematic as the IDF proposal does not foresee any sanction mechanism. Within the FTAP, an arbitration panel with jurisdictional powers jumps in if an agreement cannot be achieved. The final award of the arbitration panel is binding for all parties. States are obliged by international law to recognize and enforce it. Furthermore, the FTAP even provides a sanction mechanism to enforce final awards. The outcome of arbitration is potentially more effective than the outcome of mediation.

Qualitative differences also exist in terms of solving the collective action problem. Regarding holdouts the IDF suggests »exit consents.« They deal with the pre-existing debt stock not addressed by the CACs. Exit consents allow a simple majority and the issuers to agree on an amendment of the terms of a bond contract, without modifying payment terms and making the old issue less attractive than a new one. This provides an incentive for creditors to participate in restructuring and, consequently, reduces the hold out problem. Equal treatment of creditors would solve the free-rider problem. But even if creditors were treated equally, an individual creditor might still think that he would be better off acting as a free rider. Hence, ultimately the FTAP does not solve the holdout problem.

Both proposals advocate a stay on enforcement to address the rush-to-the-exit problem. Within the IDF debt servicing would be suspended for 90 days, whereas the stay on litigation is only an additional option. The FTAP proposes an unlimited stay that would contain not only a suspension of debt payment but also a stay on litigation. There is consensus that a stay on enforcement is a helpful feature to combat a »rush to the exit« since it is more difficult under a stay to sell the bonds. It gives the debtor time to coordinate its *creditors* and acquire new financing. It makes immediate debt restructuring possible, providing creditors with an incentive to participate. Thus, both proposals suggest a suitable solution to the rush-to-the-exit problem.

But the lack of an automatic stay on litigation within the IDF might promote the rush-to-the-courthouse problem. The temporal limitation of the stay might as well end up in creditors' litigation if there is no regulation of the time after its expiration. Applying USC Chapter 9 limits the litigation risk within the FTAP since the stay on enforcement also contains a stay on litigation. Generally, the obstacle faced by both proposals is that the rush-to-the-courthouse problem could best be solved by establishing a legal framework binding for all creditors. But as the SDRM debate showed, a legal framework is extremely difficult to implement.

In summary, the IDF's current weakness lies in the lack of a fully inclusive and equitable mechanism, while the FTAP would provide such an inclusive mechanism with equitable regulations. The FTAP's arbitration process, in combination with the sanction mechanism, would potentially be more effective than a mediation process without enforcement. In contrast, the IDF solves the holdout- and the rush-to-the-exit problems very well. The rush-to-the-courthouse problem remains unresolved. The FTAP does not solve the holdout problem satisfactorily, but solves the rush-to-the-exit and rush-to-the-courthouse problems. As a result, the FTAP can be identified as the best ideal-type solution currently available, though there is scope to improve its ability to solve the holdout problem. Useful features of the IDF, such as the integration of exit consents, could be incorporated in the FTAP to address this shortcoming. To achieve an optimum solution, the approach would have to be universal in order to make the framework binding on all creditors and to enforce the results. But as explained above, this would require international consensus, for which there has not been an obvious window of opportunity in recent years.

Conclusion

In the last ten years, we have observed a highly politicized debate in international financial diplomacy on the issue of sovereign debts and how to deal with them. Although pressure for establishing a global debt framework has become weaker in recent years, upcoming debt crises could bring this issue to the forefront once more. Generally, it is an inherent characteristic of global financial markets that debtors and creditors systemically tend to overshoot, periodically giving rise to unsustainable debt situations which end up in a liquidity crisis or a default in the worst case. Whenever such a default happens, calls arise for (i) a better preventive regulation and/or (ii) better crisis settlement mechanisms. In this article, we have taken a closer look at the latter, focusing on the problems associated with a sovereign debt default.

With the spread of Collective Action Clauses (CACs) there is currently one instrument at work which facilitates coordination of the creditors of single bonds in a default situation. The other three mechanisms discussed in this article provide more comprehensive solutions. While the IMF's Sovereign Debt Restructuring Mechanism (SDRM) and the International Debt Framework (IDF) are more pragmatically oriented, the Fair and Transparent Arbitration Process (FTAP) is more of an ideal-type solution, in the sense that it is more inclusive, equitable, and maybe even more effective than all the other approaches but faces significant obstacles regarding its implementation. Vested interests have blocked a political outcome beyond the CACs, as reflected in the SDRM debate. The current calm before the potential debt storm could be taken advantage of in order to develop a debt restructuring mechanism which would combine all the strengths of the existing proposals. The IDF's crisis-prevention and crisis-resolution approach might be a good starting point for a comprehensive mechanism. But an effective framework would have to provide a neutral arbitration body, including the authority of enforcement.

In the longer run, a debt framework is urgently needed, as it would lead to more realistic creditor behaviour and therefore reduce the inherent pro-cyclicality in the international credit market. More immediately, such a framework is needed to handle the next crisis, which could also provide the necessary window of opportunity to wrest concessions from the international financial community. Up to now, governments closely allied to financial interests have successfully impeded any international solution. Global financial governance must move beyond such particularistic interests.

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