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Briefing Paper (4/2003)

International Debt Crises: New Instruments Designed to Restructure Sovereign Bond Issues

- *The frequency with which international financial crises have occurred since the mid-1990s (Asia 1997, Russia 1998, Brazil 1999, and Argentina 2001) points to the need to reform the **international financial architecture**. The emergence of and the unregulated approaches used to resolve financial crises lead to major welfare losses in the countries affected and constitute a risk to the stability of the international financial system.*
- *Instruments tailored to restructuring sovereign foreign debt therefore constitute an essential **element** of the **international financial architecture**. However, these mechanisms have not been developed in keeping with the far-reaching upheavals which **globalization** have entailed for the international financial markets.*
- *One important feature of the expansion of globalization in the 1990s was a huge rise in and an altered structure of international capital flows. Sovereign bond issues held by heterogeneous groups of creditors assumed an entirely new significance in the 1990s compared to bank credits, which dominated in the 1970s and 1980s.*
- *In the case that a sovereign state is forced to default on a bond issue, the heterogeneous makeup of the creditor structure gives rise to serious problems involving **coordination and collective action** that cannot be resolved without recourse to new instruments. Under current circumstances a restructuring of bonds takes several years, as can be clearly seen in the case of Argentina.*
- *In view of the fact that at present most actors in the international financial markets reject an international insolvency procedure, both a voluntary **code of conduct** and **collective action clauses** constitute, in the short term, the most important instruments for restructuring sovereign bond issues. In the medium term, though, an **insolvency procedure** can play an important role here, since a procedure of this kind is a comprehensive instrument well suited to coordinating different creditor groups prior to and during a debt crisis.*

Sovereign bond issues as a new financing instrument for developing countries and emerging markets

One of the striking features of expanding globalization in the 1990s was, first of all, a huge **rise in the volume of international capital flows**. In the past decade the net inflows of private sector debt instruments into emerging markets and developing countries was at times two to three times as high as the inflows of public sector funds.

Second, the **structure of international capital flows** went through a process of substantial change in the 1990s. Compared with the 1970s and 1980s, when medium term bank loans provided by a small number of large international banks accounted for the dominant share of capital flows to developing countries, international sovereign bond issues held by heterogeneous creditor groups grew to substantially levels in the 1990s. Prior to the 1997 Asian crisis, in the years between 1990 and 1996, the net inflows of capital provided to developing countries by the private sector in the form of bonds grew from US $ 1.2 bn to US $ 62.3 bn.

On the one hand, private sector capital flows for sovereign bond issues contribute to broadening the investor base and enable investors and debtors alike to enhance their risk diversification. On the other hand, a heterogeneous creditor structure tends to entail **coordination** and **collective action problems**, and volatile capital movements may trigger welfare eroding debt and financial crises in developing countries. While it is true that the risk posed by fluctuating capital movements is greatest for short term investments such as bank loans, stocks, or currency speculation, bonds with more or less long terms are less subject to such fluctuations. But their performance, which depends crucially on economic development, may vary substantially, especially in secondary markets. This makes it more difficult for bond issuers to secure refinancing in the international financial markets. This problem is illustrated by Table 1. Net flows of capital (in the form of bonds) to developing countries declined considerably in the summer of 1997, following the Asian crisis.

Problems encountered in restructuring sovereign bond issues

The size and heterogeneous make up of the creditor groups involved in sovereign bond issues is inevitably bound up with **coordination problems** when it comes to a restructuring of such bond issues. **Collective action problems** present an additional difficulty in the restructuring of sovereign bond issues, one that may place obstacles in the way of an orderly and relatively inexpensive restructuring process.

- **The holdout problem**: A restructuring process favorable for a majority of creditors can be blocked by a creditor minority (holdouts). If creditors see a chance to enforce their claims in full following conclusion of a restructuring process likely to entail losses for them, they will have an incentive to refuse to participate in it.
- **The rush to the exit problem**: If creditors see any reason to fear that their debtor may be threatened with a debt crisis, they are likely to seek to sell their claims as soon as they possibly can. It is rational for the individual creditor to seek to be the first to sell his claims, the reason being that in the case of a liquidity squeeze on the debtor side the first creditors to sell their bonds are likely to secure a better price than the others.
- **The rush to the courthouse problem**: The risk involved here is that creditors may take legal action to secure their claims.

Table 1: Structure of net long term[a] capital flows to developing countries, 1980–2001, in billions of US $										
	1980	1985	1990	1995	1996	1997	1998	1999	2000	2001[b]
Total	82.5	73.4	98.5	260.2	306.6	341.4	336.7	271.8	261.1	196.5
Public Flows	32.6	40.7	55.9	54.1	30.3	40.7	53.4	47.4	35.3	36.5
Private Flows	41.1	21.8	42.6	206.1	276.2	300.7	283.3	224.4	225.8	160.0
Private Debt Instruments	–	21.8	15.7	63.3	96.5	98.1	89.4	5.6	8.2	-26.8
Thereof: Bonds[c]	1.1	6.0	1.2	30.7	62.3	49.6	40.9	29.5	16.9	9.5
Bank Credits	30.8	8.5	3.2	30.9	32.2	45.6	51.9	-23.3	-6.1	-32.3
Other Debt Instruments	9.2	7.5	11.4	1.7	2.1	2.9	-3.4	-0.5	-2.5	-4.0
Foreign Direct Investment	9.1	11.8	24.5	106.8	130.8	172.5	178.3	184.4	166.7	168.2

a Long term means that capital flows have a maturity of more than 1 year.
b Data for 2001 are preliminary.
c Detailed information about the type of bonds do not exist, but these are probably mostly sovereign bond.
Source: World Bank (1990), (1999) and (2002)

The example of Argentina

Argentina is a prime example of a state with a high foreign debt held by a large and heterogeneous group of creditors. At the end of 2001 Argentina suspended the service of a large share of its debt to private sector creditors. In 2003 the Argentine government made the private sector holders of its bonds a restructuring proposal under which these bondholders would have received only about one quarter of the value of their bonds. In 2002 Argentina's foreign debt was four time as high as its annual export earnings. The short term share of its foreign debt was likewise very high: expressed as a percentage of its currency reserves, the figure was 143 % in 2002. The structure of Argentina's foreign debt is a good example of the important role played by sovereign bond issues. In 2001 the public sector accounted for roughly two thirds of Argentina's foreign debt. Sovereign bonds in turn accounted for over 50 % of this debt. Aside from public sector and large private sector creditors such as banks, Argentina's creditors consisted of some 600.000 private sector bondholders, a fact which gave rise to considerable coordination and collective action problems. Another factor unfavorable to a restructuring process was that the bonds involved – a total of more than 150 different issues – were floated in eight different jurisdictions. This example clearly indicates that a restructuring procedure even for one class of debt bonds may entail substantial coordination problems. At the end of 2003 an agreement between bondholders and the Argentinian Government was not reached and not yet in sight. Probably, Argentina has lost the access to international financial markets.

Approaches for restructuring sovereign bond issues

1 Voluntary approach: a code of conduct

The proposed code of conduct published by the Banque de France (the so called Trichet proposal) is the best such proposal advanced thus far. It covers the conduct of all market actors – creditors, debtors, and the public sector – prior to and during a debt crisis; the provisions of the proposed code include e.g. a timely dialogue between creditors and debtors, a fair exchange of information among all parties involved, speedy and cooperative negotiations, equal treatment of all creditors, and continued adherence to the terms of existing contracts.

While a code of conduct can contribute to resolving collective action problems, it is not suited to fully eliminating them. A code of conduct can neither prevent a rush to the exit nor provide any formal protection against creditor litigation, nor does a code offer any safeguards against holdout behaviors.

However, a well crafted code of conduct can contribute to coming up with a procedural mechanism that sets out how debtors and creditors ought to **coordinate** a restructuring procedure with a view to rendering the affected state's debt sustainable. The principles set out in a code of conduct can contribute to resolving the following **coordination problems**:

- **Coordinating the restructuring of a single bond issue**: The aim here is to prevent a creditor minority from opting out of a restructuring measure decided upon by a majority of creditors.
- **Coordinating the restructuring of different bond issues**
- **Coordinating the restructuring of different classes of debt (bonds and loans)**: One possible coordination mechanism is application of the principle of equal treatment, which was adopted by the Paris Club for public sector loans.
- **Coordinating a restructuring process with a debtor country's economic policy**: A code of conduct can set out principles of conduct that provide for coordination of a restructuring process with changes in a debtor country's economic policy.
- **Coordinating creditors** in their attempts to come up with a decision on possible approaches to solving the problem at hand.

If a code of conduct is to prove effective, it is of the utmost importance that it will be accepted by the international community and that the parties involved develop a sense of ownership. All parties concerned – creditors, debtors, and the public sector – should therefore be involved in the implementation of a code of conduct. A code of conduct being voluntary in nature, it is necessary to create **incentives** to induce actors in the international financial markets to abide by such a code.

The role of the public sector: The public sector, including the IMF or the Paris Club, should assume an active role in applying a code of conduct. Even though, theoretically, restructuring negotiations could be proceed without any public sector involvement, this would run counter to

practical experience, and thus far debt restructuring has as a rule been linked with an IMF program worked out prior to a final agreement between debtor and creditors.

- The **IMF** could promote a code's implementation by making explicit reference to the code of conduct in its programs and its lending into arrears policy.
- The **Paris Club** could urge debtors to implement the code when the latter call for equal treatment by all creditors in connection with debt restructuring talks conducted in the framework of the Paris Club.

The role of debtors: The emerging markets should signal their willingness to adopt a code of conduct, e.g. by including the code's principles in the documents for their sovereign bond issues. It might be advisable to publish a list of countries that have adopted the code, perhaps on the model of the IMF's Special Data Dissemination Standards (SDDSs), which define the transparency obligations of member countries.

2 Contractual approach: collective action clauses

Introduction of collective action clauses serves to simplify the restructuring of sovereign bond issues. There are four different types of collective action clauses:

- **Majority clauses**: Based on majority clauses, a qualified majority of creditors can modify the terms of bond issues and thus force through a restructuring procedure.
- **Sharing clauses** require creditors who receive payments during a restructuring process to share them with other bondholders on a proportional basis.
- **Aggregation provisions** serve to aggregate bond issues and other debt instruments (loans) for creditor decision processes.
- **Collective representation clauses** are designed to accelerate the convocation of a representative forum at which both creditor and debtor positions are aired.

Most actors in the international financial markets see collective action clauses as an instrument suited to both preventing and resolving debt crises. Still, only a limited number of countries include collective action clauses in their bond issues. As a rule, collective action clauses are included in bond issues floated under UK and Luxembourg law. Bond issues floated under US, German, and Japanese law, on the other hand, do not include collective action clauses. At the end of 2001 some 75 % of outstanding international bond issues were without collective action clauses (Table 2). In 2003, though, some important emerging markets – Mexico and Brazil – floated bond issues amounting to US $ 1 bn each and containing collective action clauses. Despite the clauses the demand for these bonds was high – and both issues were oversubscribed.

Table 2: Stock of outstanding bonds by jurisdiction (End 2001)

Jurisdiction	in % of total	Number in Mn. US $	Number of bonds (excluding Bradies for USA)
Great Britain	24.1	85,182	156
Germany	10.1	35,864	89
Japan	5.9	20,716	59
USA	59.1	209,199	233
Others	0.8	3,168	21
Total	**100.0**	**354,129**	**558**

Source: IMF (2002)

Over the short to medium term collective action clauses constitute an important instrument for restructuring sovereign bond issues in emerging markets. By requiring the participation of minorities in decisions taken by a qualified majority on amendments of bond contracts, collective action clauses alleviate **coordination problems** that occur in restructuring a bond issue. They furthermore serve to ease three problems of **collective action** that may occur with one bond issue:

- The **holdout problem**: Majority clauses make it more difficult for individual creditors not to participate in a restructuring process, seeking instead to wait until the debtor is in a better financial situation in order then to enforce 100 % of their claims.
- The **rush to the courthouse problem**: Collective action clauses make it more difficult for individual creditors to take recourse to litigation to enforce their claims.
- The **rush to the exit problem**: Collective action clauses such as e.g. sharing clauses can serve to prevent creditors from selling their bonds as soon as they see a risk of a financial crisis.

Collective action clauses are, however, bound up with, basically, two disadvantages. First, collective action clauses are not a comprehensive instrument for the restructuring of sovereign foreign debt since they rule out any aggregation of different debt instruments (loans and bond issues). For this reason collective action clauses continue to be faced with holdout problems and problems with litigation between different debt instruments when different bondholder groups decide in favor of different solutions.

Second, it will prove difficult to convert old bond issues without collective action clauses into new issues with such clauses. For this reason only new bond issues should contain collective action clauses – even though this would of course mean that the entire stock of old bond issues would be without collective action clauses. An IMF study published in June 2002 found that it would be roughly ten years before some three quarters of all sovereign bond issue floated in the international financial markets contained collective action clauses. This implies a transition problem that hinges on the volume of new issues, the terms of outstanding issues, and the willingness of issuers to include collective action clauses in their contracts. It is therefore important to set incentives for issuers to include collective action clauses in their bond contracts.

In the framework of its monitoring policy the **IMF**, for instance, could seek to induce countries to make use of collective action clauses. In connection with its regular Article IV consultations the IMF could check to see whether the countries concerned have included collective action clauses in their contracts on new bond issues. The IMF could then prepare a publicly accessible list of bond issues containing collective action clauses. Furthermore, the IMF/World Bank Guidelines on Public Debt Management could be enlarged to include collective action clauses for bond contracts.

The **G10 countries** should, for the following reasons, provide their international bond issues with collective action clauses:

- First, inclusion of collective action clauses in sovereign bond issues of industrialized countries would provide a signal indicating that the practice is not a sign of poor creditworthiness.
- Second, collective action clauses would in this case no longer constitute an exceptional phenomenon in the legal systems of some countries.

- Third, market actors would in this way become accustomed to the inclusion of collective action clauses in international bond issues.

3 Comprehensive approach: the IMF proposal on an international insolvency procedure

The IMF has advanced a detailed proposal on establishing an insolvency procedure which would provide a legal framework for dealing with overindebted countries and make it possible for these countries to engage in an orderly debt restructuring process. There are four good arguments in favor of an insolvency procedure:

- First, an insolvency procedure would largely provide the means needed to solve the three **collective action problems** – rush to the exit, rush to the courthouse, and the holdout problem.
- Second, an insolvency procedure would set **incentives for a timely restructuring** because, compared with the status quo, the procedure provides for an orderly and predictable course of the restructuring process. This would make it possible to reduce the high costs which result from delays in initiating restructuring processes.
- Third, compared with collective action clauses, the proposed procedure is a comprehensive approach that can be used to restructure different types of debt (bonds and loans) at the same time.
- Fourth, the proposed procedure would make it possible to involve private sector creditors in the resolution of debt crises.

Many actors in the international financial markets reject an international insolvency. Most **developing countries and emerging markets** do not support the proposal for the following reasons:

- First, developing countries could lose access to the international capital markets once such a procedure had been initiated. But since access hinges on a country's overall economic development, a debtor country would have a chance to improve its reputation following an insolvency procedure by enhancing its economic performance, in this way regaining access to the international capital markets.
- Second, the financial support provided by international financial institutions in cases of crisis might decline in connection with the adoption of an insolvency procedure. The IMF does not, however, intend to tighten up its criteria for lending to countries that have initiated an insolvency procedure.

Private sector creditors, in particular banks and banking associations, generally reject the proposed international insolvency procedure for the following reasons:

- First, the private sector actors in the international financial markets, banks in particular, fear that the procedure might serve to reinforce **debtor moral hazard**. Since the procedure would make it easier for debtors to open insolvency proceedings, they might be tempted to take advantage of the procedure. Whether or not a debtor country will be able to derive benefits from an insolvency procedure will also depend on the negotiations it conducts with its creditors, who have considerable say in the procedure.
- Second, private sector actors are of the opinion that the insolvency procedure might even trigger a financial crisis in debtor countries, since private sector actors would withdraw their short term capital from such countries as soon as an insolvency procedure was announced. But it should be noted that a financial crisis would be triggered only if actors in financial markets believed that an insolvency procedure was going to lead to a suboptimal result.
- Third, private sector actors criticize the debt categories marked for inclusion in the IMF's proposed insolvency procedure, especially the inclusion of credits provided by multilateral and bilateral international organizations. This would tend to lower the acceptance of the proposed procedure by other creditors, unsettling the markets.

Even though the proposed international insolvency procedure is at present rejected by most actors in the international financial markets, it could prove to be an important instrument for restructuring sovereign bond issues, and one that could solve the three collective action problems outlined above. Moreover, the proposal on an international insolvency procedure would be well suited to solving the problem of aggregating different debt classes, credits and bonds and grouping debts within these classes.

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