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SOVEREIGN BANKRUPTCY: A PIECE OF THE INTERNATIONAL FINANCIAL ARCHITECTURE IS STILL MISSING

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Contents

Introduction 1
Desirable Characteristics of a Sovereign Insolvency Regime 5
Experiences in Low-Income Countries 6
The Initial Model: Temporary and Short-Term Relief 6
The Current Model for Low-Income Countries: the “Fresh Start” 8
Further Reforms and Loose Ends 10
Experiences in Market-Access Countries 12
From Syndicated Bank Loans to Bonds and Collective Action Clauses 12
Market Based Swaps as a Mechanism for Restructuring 15
Conclusion: More Powerful Instruments are Needed 17
References 20

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“When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonorable to the debtor and least hurtful to the creditor.”

Adam Smith (1776)[1]

the sense of relations among states or between a state and private (usually foreign) entities.

Sovereign insolvency is also political in another important sense; i.e., sovereign debt crises have become foci of internationally forceful political movements. Most prominent among these is the Jubilee 2000 campaign for debt cancellation for the poorest countries, whose broad popular mobilizations caused creditor governments and multilateral financial institutions to repeatedly break with their announced policies and agree to cancel, albeit grudgingly, increasing amounts of poor country debt in the 1990s and the present decade.[3] Sovereign debt problems in developing countries were perceived as pitting poor countries against rich creditors, inhibiting the ability of the poor people in those countries from raising themselves out of their poverty. Similarly, the debt crises in middle income countries, which have been mainly indebted to private creditors, were seen to have plunged millions of people back into poverty.[4] The basic charge was a political one: the approach lacks justice.[5]

One should want the debt workout regime to show ex post (after default) and promote ex ante (before default) efficiency and equity (see Stiglitz 2002, pp. 16-18). A workout regime with ex post efficiency would minimize the economic dislocation and pain in the economy of the defaulting government, promote economic growth and return
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1907.[6] Creditors at the time were primarily bondholders, as is increasingly the case today as well. Typically organized into creditor committees, the bondholders first sought to collect on the defaulted claims of sovereign borrowers themselves and when this failed sought assistance from their own governments. Representatives of the creditor governments would then negotiate with the debtor or plead the creditors' case in an arbitration proceeding.[7]

Apparently, on average, the debt crisis workouts under the pre-war regime had certain advantages over those of the post-war regime, albeit also certain disadvantages. In particular, the sovereign debtors seemed to receive greater degrees of relief from their private creditors, but it generally took longer to settle the creditors' claims, during which interest arrears typically accumulated as well, sometimes exceeding the original defaulted principal (Suter and Stamm, 1992). The point is not to express nostalgia for the pre-war years, but to remember that the current system is the product of our times. Previously, the governments of the powerful countries directly represented the interests of their resident creditors, while today many would say the powerful governments indirectly represent creditor interests through their influence in the multilateral institutions. Representatives of private creditor associations might strongly dispute that assertion, complaining that the international financial institutions are both political organizations that favor the debtors for foreign policy reasons of the powerful countries and creditors in their own right. Perhaps this means that none of the stakeholders are happy with the current system.

In the subsequent sections of this paper, we first describe in more detail what we find to be desirable characteristics of a sovereign bankruptcy regime. This serves as a normative benchmark for the remainder of the paper. We then suggest how the current system for relief of low-income country debt appears to have exhausted itself

Desirable Characteristics of a Sovereign Insolvency Regime

All restructuring agreements around the world, although under different frameworks, have the same objective: an early-negotiated deal based on a fair, predictable, participatory process. Although there are other effective bankruptcy regimes, U.S. bankruptcy law presents one such framework. Under U.S. law, debtors are treated differently depending on their juridical nature. For example, chapter 11 (for corporations) focuses on maximizing the value for creditors. In contrast, chapter 9 (for states and localities) focuses on limiting the pain for governments, given that it is not considered ”fair” for creditors to take government assets or excessive amounts of future

with their creditors

official creditors should sacrifice equally, or at least the bilateral ones, as multilateral obligations were left untouched by implicit mutual agreement, at least until recently. The Club members also devised standard terms of relief to apply to countries in different economic situations, revising them over time, but in general not following a "case by case" approach (albeit granting relief to individual country by individual country). The Club is, however, informal and the "Agreed Minute" setting out the broad terms of relief that is adopted at the end of a Club meeting on a country still has to be negotiated loan by loan by the debtor with each individual government creditor.

How wedded to this process are the creditor governments? They have only departed from it for politically important cases, of which there have been several. The first was Turkey in the 1960s, owing to its strategic importance as a member of the North Atlantic Treaty Organization. Second was Indonesia after the fall of Sukarno, when, after a series of standard Paris Club agreements (1966, 1967, and 1968), the donor governments supporting Indonesia invited Dr. Herman Abs, a renowned German banker, to recommend a settlement, which was adopted (with amendments) in 1970. His proposal embodied a grant element of 60 percent, amortization over 30 years and no interest payments for 15 years (Klein, 1973, p. 20). In addition, the agreement contained a "bisque" clause that allowed Indonesia to defer *at its option* up to half the principal due during the early years of the arrangement (Cosío-Pascal, 2006, p. 9). This was clearly a deeper degree of relief than the Club was extending to other countries and indeed Nkrumah's Ghana repudiated its almost simultaneous rescheduling agreement in part because it compared so poorly with that for Indonesia (Ghana did not settle until 1974).

Special treatment was also accorded later to Poland in 1990 and Egypt in 1991, two middle-income countries that ultimately saw their debt cut in half at a time when nothing like this degree of relief was being accorded to much lower income countries. The political importance to the creditor governments was clear in supporting Poland as the Iron Curtain crumbled and assisting Egypt following its support of the allies in the first Gulf war against Iraq. Iraq also received special treatment in the promise of an 80 percent reduction of its Paris Club debt in 2004. The Paris Club press release announcing that agreement on November 21, 2004 cited the "limited repayment capacity over the coming years" as the rationale for the permanent cut in Iraq's debt stock, something that in other circumstances might have been considered a non-sequitur.

Initially, the Paris Club did not see its function as returning the debtor to a sustainable debt situation, but rather buying time for adjustment policies to work (not to mention waiting for global economic recovery to take place, as debt servicing difficulties were sometimes associated with recession-related collapses in commodity export prices). The distinction commonly drawn today between liquidity and solvency problems was not considered in those early years. Consequently, debts were not reduced (except in the special cases noted above); rather, debt-servicing obligations were postponed. Commercial interest rates were usually charged on the delayed payments, in essence, making the rescheduling a form of concerted refinancing. Middle-income countries and the poorest of the poor received the same type of treatment.

The short-term focus was driven by the standard analyses prepared by IMF of the

debtor country's economic and financial adjustment needs. The Fund's mandate was to help member countries correct balance-of-payments problems, not development problems. The Fund in effect focused on the short-term net cash flow of the debtor vis-à-vis its foreign creditors, its so-called "net transfer of financial resources." This made the conceptual and policy link very strong between new credits and relief of debt servicing, especially as the creditors were virtually all official institutions. That is, a country could be supported with the same net transfer either through additional loans or additional relief.

Once a crisis began, virtually the only credits a debtor could receive would be bilateral official development assistance (ODA) and multilateral loans.[13]

(which could be restated as Paris Club recognition that these debt were non-

available to all countries meeting a particular income criterion (per capita income below US$ 380 per year), which added two non-HIPCs to its relief recipients.[19] Why this specific

Yes, but it will take political mobilization to get there. Before collectively throwing up hands at that remark, one may underline the sea change in international debt policy regarding the poorest countries that was embodied first in the HIPC Initiative and then in the MDRI. It resulted from insistent political pressure from below on a number of the major creditor governments, pointing out their commitments to certain international goals and the reasonable expectation that they were not doing enough to reach those goals in most low-income aid-

community, are making increasing financial offers to low-income countries.[20] These other governments provide potential alternatives to the policy-package-*cum*-financing of the traditional donors. While some of the new financial offers are grants, many are loans and the traditional donor community already sounds exasperated that these "free riding" lenders may drive debt levels back to unsustainable levels.[21] Unmentioned is that these creditors may also abide policies outside the mainstream advocated by the traditional donor community. If this or some other scenario brings the poorest countries again into external debt crises, they will likely seek a different debt workout mechanism than the donor-directed one that they have operated under over the past decade and more. Right now, none such exists, although the last section o12.

than a “statutory” approach and less likely to disturb the “voluntary” and informal nature of restructuring the obligations to private creditors.[24] Today, most countries include CACs in their new bond issues. However, CACs cannot address conflicts between different classes of creditors (such as bondholders, banks, multilateral lenders, and bilateral lenders).

The main function of CACs is to specify how to reach a decision to restructure a bond. The CAC process is conceptually similar to the one followed in the 1990s and early years of the present decade, except that it pre-specifies the “supermajority” required for adoption of the new terms.[25] In actual application, one might expect the defaulting sovereign to sound out major groups of bondholders, as with pre-CAC bonds, and then to unilaterally offer a new deal on which the bondholders would vote. With pre-CAC bonds, bondholders “voted” by offering their old non-performing bonds in a swap for a new bond that would either have a more favorable repayment profile or a reduction in the face value or interest rate. To discourage holdouts, participants in the swap sometimes voted on “exit consents,” which changed the terms of the old bonds so as to reduce their legal standing.

It is not clear if CACs will prove important to the successful completion of future bond swaps or other restructurings.[26] Bonds issued under British law have traditionally incorporated them. In addition, the “exit consent” mechanism used in the Ecuador and Uruguay debt restructurings seemed to provide an alternative approach to the use of CACs. Moreover, Argentina’s debt restructuring relied on neither CACs nor exit consents (although the new bonds include CACs). It attracted 76 percent of bondholders and was declared valid. Holdouts have protested loudly, have gone to court in various jurisdictions and have recently even had a case accepted at the international arbitration panel operated by the World Bank (the International Center for the Settlement of Investment Disputes). Not one holdout, however, has yet to see a dime, although favorable court decisions have been made in certain jurisdictions. In short, the “contractual approach” bumps up against the unenforceability of contracts with a sovereign. CACs are simply a way to help organize the vote on a “voluntary” exchange of new bonds for old ones.

It also appears that the effort to bring a form of "relationship banking" to a world of bond finance is having only limited effect. That is, following the Mexican crisis of 1994, there was both an effort to encourage governments of emerging market countries to provide more and more up-to-date data to the international investing public, and an effort to improve the discussions between borrowing governments and their private creditors. The former became the IMF's Special Data Dissemination Standard, to which most emerging market countries have subscribed, and the latter has been turned into the

[24] The reason that unanimity provisions were originally incorporated into securities issued under New York law was to protect the rights of minority shareholders and ensure that a majority (or a super majority) did not use their voting power to deprive a minority of their “rights.” The new CACs in New York law bonds reversed that position.

[25] It would also reduce the legal standing of bondholders that did not agree to participate in the restructuring.

[26] For a rather skeptical view, see Gelpern and Gulati, (2007).w039 thayTw ( ) Tj -88.

"investor relations programs", government committees that engage with creditor groups via conference calls and other means. An additional initiative was to develop a "code of conduct" for how creditors and debtor governments should interact. The latter became the "Principles for Stable Capital Flows and Fair Debt Restructuring" (IIF 2005), which has been endorsed in the private sector and welcomed by a number of governments, as reported by the Institute of International Finance (IIF 2006). However, there does not seem to be a practical embrace of the consultative processes that underlay the idea of the code. In short, bondholders are not like old-fashioned bankers who develop ongoing and personal relations with clients over time. The nature of the current financial relationship is rather more arms' length.

It is also unclear what the future of restructuring exercises through bond swaps – or indeed, new bond international bond issuance – will be after Argentina. A large number of Argentine bondholders did not accept the swap, and their efforts to collect funds through court actions all but preclude Argentina from returning to international financial markets. This has not hurt Argentina as yet, as international bond buyers have been attracted to Argentine bonds issued under local laws. Also, Argentina has not needed much borrowing. Finally, the announcement by Ecuador that it might not make its February interest payment and seek restructuring was a blow to market confidence, as the country is not in a current debt crisis but rather feels it is imperative to change the terms of its borrowing to less disadvantageous ones. How confident should creditors be, in other words, that Ecuador or other debtors might not seek to reopen bond agreements that governments find were inappropriate, let alone "odious"?

Market Based Swaps as a Mechanism for Restructuring

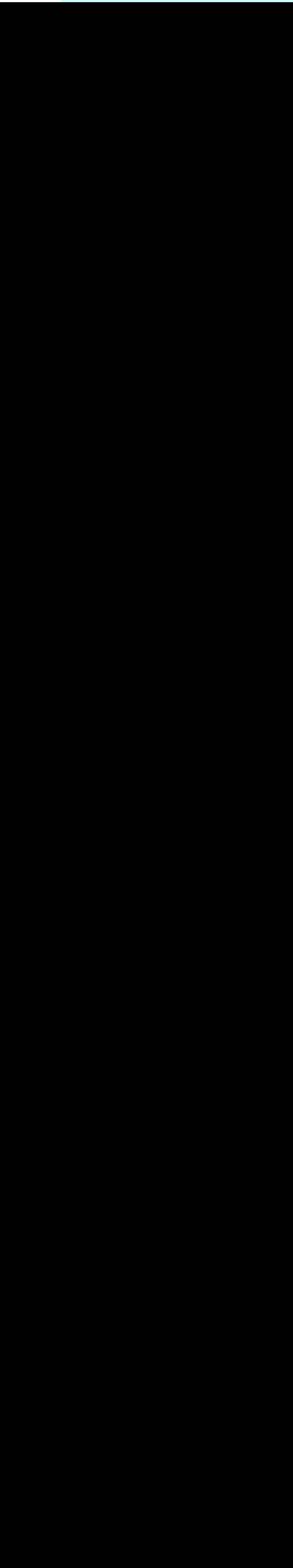
Most of the recent market based swaps have been successful in solving the creditor coordination problem – they have generally represented quick and somewhat orderly restructurings. However, as stated earlier, market based swaps have not been as successful at reducing debt levels. They do not give countries a clean slate. Indeed, the aim of many of the swaps has been to accord enough breathing space to the debtors to ease a constraint on economic recovery in order to return the debtor to full debt servicing and full market access, rather than reduce debt levels. Table 1 shows information on five restructurings through that occurred between 1997 and 2005. The first notable point is that the swaps extended maturities and offered new bonds at lower interest rates than the market would have priced on its own, but only one country, Ecuador, experienced any write-down in principal.

Table 1: Sovereign debt distressed exchanges 1997-2005

Source: Bloomberg, or as indicated.

Country	**Year**	**Type of event**	**Description**	**Exchange terms**	**Moody's recovery proxy**

	Exchange accepted: extended maturities but no write-down of principal. Note: events preceded by severe banking crisis in 2003.	Late payment on Brady



Because there is no clear definition of bankruptcies for sovereigns, the recovery value is a matter of negotiation. The implication is that, when default does occur, there is large

The argument in this paper began by indicating how the debt problems of low-income countries have largely been subsumed in their aid relationship with their major donors, from which aid donors would do well to look at experiences in monitoring HIPC relief for lessons that might be applied to the aid relationship more generally. We also noted, however, that other, new creditors are lending funds to these countries and that the donor-dominated debt-workout process may not be attractive to sovereign debtors or some of the creditors in a next round of debt crises. Right now, there is no other option, whether the creditors to these countries are private or foreign governments.

If the above paragraph hints that there is a missing piece in the international financial architecture, the argument in the rest of the paper seeks to make that claim definitively. It is clear now that it is in the nature of the private foreign financial claims against a sovereign that courts cannot enforce them and that lenders necessarily bear a measure of risk in lending to governments. Credit default swaps are an easily understood response. It is also argued that informal processes that maintained creditor discipline in the era of bank lending had run their course by the end of the 1980s and would become even less effective in the era of bond finance. Finally, a voluntary code of conduct was no solution, as it could discipline neither the debtor nor the creditors. This does not imply that every sovereign debt crises will end in chaos. Somehow they are eventually resolved in every case. For the resolution to be timely, effective, and fair, however, some stronger initiative is needed than we have yet seen, one that uses the state and law in a different way.

In fact, powerful states have usually been central to workouts from major financial crisis. While concerted meetings of bankers may have saved Korea from default at the end of 1997 and rescued the US financial markets from the challenge of Long Term Capital Management in 1998, it is important to recall that the concerting was done by the Federal Reserve Bank of New York and the US Treasury. Perhaps the last time the private sector rescued a country from financial crisis was when J.P. Morgan coaxed some of his banker friends at his apartment on the 31st floor of 14 Wall Street to work with him to finance the workout from the U.S. financial panic of 1907. That experience, however, prompted the US authorities to create the Federal Reserve System. At global level, a strong, well-financed and more representative IMF, inspiring high confidence in debtor as well as creditor countries, seems to be the essential starting point.

The IMF, however, is not also the end point. The Fund's experience in proposing to create the Sovereign Debt Restructuring Mechanism (SDRM) in 2001-2003 is an important experience to learn from. SDRM was rejected for shortcomings in itself (for example, being perceived as an arm of IMF, and not an independent forum), and as a representative of all "statutory" approaches, which the private creditor market feared would reduce the recovery value of their non-performing loans in a default situation (most likely an exaggerated fear, post Argentina).

It also seems that the SDRM failed because it was rushed from vague idea to concrete legal proposal before enough of a constituency developed in support of it.[30] It

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