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Technical Study Group Report: Sovereign Debt Restructuring: Further Improvements in the Market Based Approach[1]

Introduction

In the absence of an insolvency regime for sovereign obligors, debt crises are primarily dealt with on an individual case-by-case basis. Debtor countries seeking to normalize their financial position at such times are typically compelled to seek debt relief from their creditors in the form of an extension of the maturity of the claim, a reduction in the value of the claim and/or relief on interest payments. However, debt restructurings are often "too little too late"[2] and especially problematic pre-default and vulnerable to holdout creditors. The underlying motivation to develop a better framework for the timely, orderly restructuring of sovereign debt is the perception that the status quo increases costs on all stakeholders. Any delay to a necessary debt restructuring reduces the size of the pie and is detrimental to both the debtor country and its creditors, with the apt adage of "too much pain for too little gain." Protracted negotiations adversely affect the debtor and limits continued market access and foreign investment, often taking place in scenarios of economic recession, high unemployment and public expenditure challenges. Creditors are also harmed, as continuing uncertainty at a time of competing policy challenges for countries can lead to asset values being dissipated and balance sheets vulnerabilities persisting for longer periods; In addition, the IMF's credibility and effectiveness in assisting its members to strike a judicious balance between financing and adjustment can be impaired.

b) Creditors who insist on the highest possible recovery within the IMF sustainability envelope may be driving a hard bargain, but should not be in bad faith.

In sum, treat good faith in IMF policy as a safety valve *in extremis*, to police against behaviour likely to produce unsustainable or inequitable outcomes—not as a routine test of debtor or creditor behaviour in the restructuring process.

9. How does bank regulation affect sovereign debt restructuring? What are the open issues in regulation affecting sovereign debt?

In a survey of the legal, regulatory, accounting, tax treatment and market disclosure requirements as they relate to sovereign debt, mainly from U.S./European perspectives an expert catalogued the extensive range of legal, regulatory, accounting, tax treatment and disclosure requirements across jurisdictions worldwide that affect sovereign debt. It was noted that, except perhaps in the regulatory sphere, there was little uniformity of practice and little impetus towards convergence. Many examples were provided of disparate practices. A good example was the EU Transparency Directive, which gives existing holders of securities the right to access bond documentation but not to potential buyers of securities. This was contrasted with U.S. practice, where disclosure is publicly available to all interested parties. At the same time, disclosure requirements by sovereign bond issuers also varied, both in timing and content, and national political obstacles stood in the way of coalescing around agreed standards. Other examples mentioned include the regulation of Credit Rating Agency sovereign ratings, and tax and accounting issues, where practices vary globally. The experts concluded that a comprehensive study of these issues, much less reaching a policy consensus on how to tackle them, would be a multi-year project.

Banks regard most sovereign bonds at most times not as investments but as a form of money. This results in a classic case of multiple equilibria. Sovereign bonds have two market equilibrium states; one as a risk-free asset; the other as a credit investment, and the gap between the price of assets in these two market states is very large. Thus in the sovereign bond market credit premiums tend not to increase linearly in line with economic and fiscal policies—they remain unnaturally low for an extended period into a dowiowk

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c) At *stage three*, market prices and expected losses are likely to converge. Once stage three has been reached, banks are usually prepared to enter into restructuring negotiations, since they will already have taken capital charges equal to the likely losses on such restructuring.

An optimal regulatory structure in this regard would be one which moves banks through these stages as quickly as possible, and which removes any positive regulatory incentives to disinvest at an early stage (thereby adding to a downward market spiral).

The composition of liabilities, the structure of banks, and creditor hierarchy are all important considerations with respect to bank regulation issues. There is a systemic risk between sovereigns and banks that they may pull each other down in the event of a problem. When banks buy themselves time in resolution, sovereigns stand to suffer as the time lost results in a delayed resumption of growth and debt sustainability

The banking and sovereign debt spheres are somewhat parallel in that they are both systemic in nature.

see these long running issues that the market gets caught up with and they are just as procyclical. In fact in some cases they are more procyclical than where the market is and late in their assessments.

A key issue is to disentangle the issue of how the regulatory capital system should apply to holdings of sovereign bonds generally, and how it should apply in the case of specific sovereign bond restructuring. There are good arguments for the imposition of capital requirements in respect of sovereign exposures generally, and this discussion does not address these. However, in the case of a particular sovereign, it is important that the regulatory system does not create positive disincentives for banks to participate in sovereign restructurings.

Basel is currently engaged in a major review of the risk capital treatment of sovereign

In relation to the treatment of risk weighting for bank capital, the best outcome from the Basel process would be a pillar 2 charge, designed to de-incentivise undesirable speculation in the bonds of distressed sovereigns whilst mitigating regulatory pressures on banks to liquidate assets in advance to the completion of a resolution package. The structure of such a mechanism would have to be transparent, and embedded in international standard practice and take broadly the form of the capital charge sacrifice model applied in the UK Funding for Lending scheme.[19] The [illegible]