A SWOT-Analysis of the IMF's Proposal for Insolvency Procedures to Reduce Sovereign Debt

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1 Introduction

Indebtedness of developing countries has been on the international agenda for more than 20 years. Despite a rapidly changing economic and political environment, important areas of the debt problem still remain unsolved. A major achievement is the World Bank's and IMF's Heavily Indebted Poor Countries (HIPC) initiative which brought partial relief to a number of countries[1].

Nourished by the experiences of domestic bankruptcy regulation, already in the late 1980s a lively public debate[2] developed in Switzerland on insolvency procedures for developing countries, well ahead of the present global endeavour to establish a sovereign debt restructuring mechanism. There was at that time, however, no political backing on the side of the Swiss Government.

2 The Problem

A country ("sovereign") may find itself, through some combination of bad luck and bad policies, with an unsustainable debt burden[3]. A sovereign debt is unsustainable when, under any realistic set of policies and circumstances that can be envisaged, the debt-to-GDP ratio (or debt-to-export ratio in some cases) will rise to levels which cannot be reasonably reduced over the medium and long term. In such cases, in one way or another, the country's debt has to be restructured

Such a process of restructuring is costly and painful, economically, socially and politically, and so a country's policymakers typically delay entering into a discussion with their creditors. Ordinary people can end up paying a tremendous economic and social cost as a result. Creditors are also damaged by such delays.

Currently, the international financial system lacks a strong legal framework for the predictable and orderly restructuring of sovereign debt, which drives the cost of default or repudiation even higher.

Difficulties in restructuring debt can arise in several areas, including:

- **Collective action**: A restructuring solution that is acceptable to the majority of creditors can be vetoed by one or a few minority creditors who wish to "hold out" for more favorable terms for themselves.

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[1] See http://www.jubileeresearch.org/hipc/progress_report/briefing070103.htm for an intermediate independent summary assessment.

[2] A chronology is established in the Annex.

[3] We often use here the International Monetary Fund's Fact Sheet on the SDRM, see http://www.imf.org/external/np/exr/facts/sdrm.htm

- **Creditor coordination**: Governments of emerging markets now issue debt to numerous and anonymous creditors with diverse economic interests, in different legal jurisdictions, and using a variety of instruments, making creditor coordination extremely difficult.

The debt problems of low-income countries are being dealt with under the Highly Indebted Poor Country (HIPC) initiative. The SDRM addresses issues concerning sovereign debt to private sector creditors, and is thus more relevant to emerging market countries that have borrowed on international capital markets.

The international community is trying to create a framework for an equitable debt restructuring that restores sustainability and growth, without providing incentives that unintentionally increase the risk of default.

3 Options

In April 2002 the International Monetary and Financial Committee (IMFC) encouraged the IMF to investigate a "twin-track" approach to solving the problem of unsustainable debt. Two options were analyzed:

- The first option, a statutory approach, would create a legal framework, the so-called “Sovereign Debt Restructuring Mechanism, SDRM”, that would allow a qualified majority of a country's creditors to approve a restructuring agreement which would be binding on all. In order to make the agreement binding on all creditors, enactment of a universal statutory framework would be necessary.
- The second approach would incorporate comprehensive restructuring clauses, so-called "collective action clauses (CACs)" in debt instruments. Collective action clauses, found in sovereign bond contracts, limit the ability of dissident creditors to block a widely-supported restructuring on an individual bond issue.

Option 1: Sovereign Debt Restructuring Mechanism (SDRM):

The central objective is to put countries and their creditors in a better position to restructure unsustainable sovereign debts in an orderly and timely manner. The SDRM would provide the legal basis.

Better incentives for debtors and creditors to agree on prompt, orderly and predictable restructuring of unsustainable debt are needed. Domestic bankruptcy law serves as a useful model in the insolvency context, but the applicability of the corporate model is limited by the unique characteristics of a sovereign state. We are not proposing a bankruptcy mechanism for countries, but simply a mechanism to facilitate debt workout negotiations between a debtor and its creditors.

Guiding principles, strengths, weaknesses, opportunities and threats of the SDRM proposal are set out in chapters 4 and 5 below.

Option 2 : Collective Action Clauses (CACs):

Collective action clauses would permit a specified super-majority of holders of a particular bond issue to agree to a restructuring that would be binding on all holders of that issue. They apply to individual bond issues. By preventing holdouts in individual bond issues, such clauses would thereby facilitate any needed restructuring. Currently, most bonds do not include these clauses.

In a general restructuring, the CAC approach would require separate decisions from holders of each individual bond issue. Creditors of issues not accepting a restructuring offer would have the right to pursue their interests in the courts in the country/state under whose laws the debt instruments were issued.

The use of CACs would be an improvement over the current system and the IMF is prepared to promote their use among its member countries. The SDRM proposal goes farther than CAC and – in the IMF's view – could complement them nicely. The SDRM is a more comprehensive approach than CACs because the SDRM would deal with the whole existing stock of debt categories involved, including instruments that do not explicitly provide for collective action. SDRM guided restructuring would be much simpler as the SDRM would allow a single vote to restructure multiple debt instruments by aggregating the votes of creditors holding participating debt instruments. Furthermore, the SDRM would provide for an impartial dispute resolution process allow the injection of new money.

Both approaches have been subject to intense and constructive debate, within the IMF and in other fora, throughout 2002. The IMFC reviewed progress at its September 2002 meeting, endorsed the Fund's work and requested the IMF to develop a concrete SDRM proposal for consideration at the April 2003 Spring meetings. The features, analysis and recommendations below refer to this exploratory search process of the IMF's SDRM proposal.

Option 3: Fair and Transparent Arbitration Process (FATP)

It should be noted that civil society organisations propose a third option, an alternative "Fair and Transparent Arbitration Process (FTAP)" [4]. They criticize that the SDRM does not improve the balance of power between debtor and creditors as it leaves crucial decisions to creditors and the debtor and thus avoids the need to create the equivalent of a bankruptcy judge that has the power to grant a debtor legal protection. The SDRM just redistributes powers from individual creditors to a super-majority of creditors. Therefore, the weaker party in negotiations is not strengthened. Policies are not supervised by a bankruptcy court. In contrast the FTAP mechanism is based on the model of Chapter 9, for municipalities, of the US Bankruptcy Law[5]. In such a way NGOs push for a safeguarding basic needs of the poor, for a voice of the population in the restructuring process and for keeping the mechanism at arms' length from the IMF because the IMF should not become judge of its own affairs. This vision may become important as and when the establishment of the SDRM

[4] See the alternative concept for a Fair and Transparent Arbitration Process (FTAP) in http://www.erlassjahr.de/15_publikationen/15_dokumente/englisch/positionpaperinenglish.rtf; the IMF/ NGO discussion in http://www.cidse.org/en/tg3/sdrm0902.pdf; the critique in Raffer Kunibert, The IMF's SDRM – Another Form of Simply Disastrous Rescheduling Management? (unpublished)

[5] See e.g. Raffer Kunibert, Applying Chapter 9 Insolvency to International Debts: An Economically Efficient Solution With a Human Face, in: World Development, Vol. 18, No. 2, pp.301 – 311, 1990

requires an amendment of the IMF's Articles of Agreement which is subject to parliamentary approval in many member countries.

4 Guiding Principles

Key features of the IMF's SDRM proposal are:

Majority decision: The mechanism would allow a sovereign and a qualified majority of creditors to reach an agreement that would then be made binding on all creditors that are subject to the restructuring. A debtor cannot use the SDRM without the consent of a supermajority of its creditors

Deter disruptive litigation: The mechanism would discourage creditors from seeking to enhance their position through litigation during the restructuring process.

Protecting creditor interests: Creditors would have assurance that the debtor will pursue policies, most likely designed in conjunction with seeking financial support from the IMF, that help protect the value of creditor claims and help limit the disruption of the economy.

Dispute resolution: A dispute resolution forum would be established to resolve disputes that may arise during the voting process or when claims are being verified.

Transparency: The SDRM would, among other things, enable creditors to have information about how others are being treated during the restructuring process.

Priority financing: As a means of inducing new financing, an SDRM could exclude a specified amount of new financing from the restructuring, if such exclusion were supported by a qualified majority of creditors.

5 SWOT-Analysis

Strengths:

- ***The SDRM contributes to crisis prevention****.* By providing greater clarity concerning the circumstances under which debt would be restructured and the process that would be followed, private markets would reduce lending to countries with already high debt-to-GDP ratios.
- ***The SDRM reduces costs to deal with non-sustainable debt for the creditors and the debtor***. A less disorderly and drawn out debt restructuring process would be to the benefit of all concerned. The citizens of the countries whose debts are being restructured would benefit as the period of economic dislocation is reduced. And creditors would gain since their asset values are preserved.
- ***The SDRM increases the efficiency and stability of the global financial system***. By creating a more predictable environment for workouts in cases of unsustainable debt burdens, the overall risk of lending to emerging market countries would be reduced. This should lower the costs of accessing markets for emerging market countries with strong policies and stabilize capital flows.

Weaknesses:

- ***The SDRM does not protect minimum living conditions of the debtor's poor against creditor claims.*** The result will be that the misery of the crisis ridden poor population will continue despite debt reduction efforts of private creditors. The path to medium-term viability must not violate basic needs of the population. The protection of minimum living conditions for the people would all the more be justified as the IMF exerts a big influence on the debtor's economic policies during the restructuring period.
- ***The SDRM does not provide opportunities for the affected population of the debtor country to voice their concerns***: The right of people to be heard by representatives beyond their government should also apply to the SDRM process. The rules of Chapter 9 of the US insolvency procedures give labour unions and employees' associations the right to be heard[6]. These rights are seen as a form of protecting the municipalities' public character and governmental power. Similarly, an opportunity to enhance SDRM process legitimacy, effectiveness and acceptance of the results by civil society participation is missed.
- ***"Odious" debts are honored at equal terms in the SDRM process***: The SDRM limits its interference with contractual relations to those measures that are needed to resolve the collective action problems. It does not touch the legitimacy of debt related to arms purchases, debt accumulated by previous non-democratic or corrupt regimes, etc.. There is a considerable debate whether to refuse to "odious debts" the favor of inclusion into the SDRM process.

Opportunities:

- ***The SDRM strengthens the international framework of financial markets***. As more countries gain access to private capital markets a framework for the more orderly resolution of unsustainable debt situations, in those rare cases when they do arise, will be of help. The establishment of an SDRM avoids in future the present muddling through sovereign debt crises.
- ***Capital flows are encouraged and capital costs decrease***. In the domestic context, the existence of a bankruptcy law makes debt markets more efficient. Similarly, the SDRM is to reduce uncertainty surrounding the process of restructuring, and to provide effective incentives for debtors to approach their creditors before full-blown crises take hold. Recovery values on restructured debt increase, and the cost of capital declines.
- ***The establishment of the SDRM facilitates targeting of scarce IMF resources***. There is consensus on the principle that IMF financial support should be geared to countries with (temporary) liquidity problems and not to countries with unsustainable debts. It may become less evident to take the IMF for a ride to provide support purely for political considerations.

Threats:

- ***An exclusive, only partially applicable SDRM privileges non-cooperating creditors and undermines its credibility.*** Some creditor categories, notably multilateral debt and bilateral official debt will most probably not fall under the SDRM procedures. This is a serious weakness which may undermine the overall

[6] Raffer 1990, p. 303

credibility of the SDRM. It is well known that the Highly Indebted Poor Countries (HIPC) initiative suffered from many problems related to excluded creditors.

- ***If restructuring of sovereign domestic debt is not coordinated, the overall burden cannot be reduced to a sustainable level.*** Nonresident investors may only be willing to provide substantial debt reduction if they know that domestic creditors are shouldering a fair share of the burden too. Governments typically have at their disposal tools for restructuring domestic debt that are not available in the case of external debt.

- ***Sovereign debtors could be tempted to build up an unsustainable debt burden because the SDRM provides an orderly workout (moral hazard)***. Even then, however, debt restructuring remains a costly option. The prospect of economic dislocation, political upheaval, and damage to the country's reputation in international capital markets are high barriers which remain.

6 Recommendations

- It is recommended that the ***SDRM objectives are amended*** as follows: "The objective of the SDRM is to provide a framework that *facilitates a fresh start for the debtor* and strengthens incentives … in a manner that *protects the basic needs of the debtors' population,* preserves the economic value of assets and facilitates a return to medium-term viability."
- The IMF shapes to a large extent the outcome of the SDRM, while being itself involved as a debtor. The power of the Sovereign Debt Dispute Resolution Forum (SDDRF) should include the possibility to ***challenge also decisions of the IMF***, in particular on the amount of debt reduction needed to resolve the debt crisis.
- The SDRM proposal requires an amendment to the IMF's Articles of Agreement. This again will necessitate parliamentary approval with a voluntary referendum clause in Switzerland. A ***careful analysis of the conceptual and political implications*** of such public debate is absolutely essential.

A summary of the views of the Fund's country shareholders, represented by the Executive Directors, revealed dissension between Executive Directors as well as tensions between Fund Staff and shareholders. It should also be noted that the private financial sector, represented by the Institute of International Finance (IIF)[7], has a preference for the CACs option which is perceived as less interventionist. While recognizing the progress made, NGOs continue to bring forward some major reservations[8]. At the political level, the SDRM proposal still has to go a long way.

[7] See Institute of International Finance, http://www.iif.com/data/public/SDRM.pdf
[8] See Jubilee Research: http://www.jubileeresearch.org/latest/sdr220103.htm

Annex

Swiss SDRM related history

In the late 1980s and early 1990s, the idea of a Swiss initiative related to the creation of a SDRM was debated in various circles and up to the highest level. A chronology of key points in the debate follows:

- On 12 June 1989, the Federal Council (Council of Ministers) approves the creation of an Independent Expert Group on International Debt[9] to submit proposals how Switzerland could contribute to solve the problems of the indebtedness of developing countries.
- On 31 October 1989, the expert group submitted its proposals to the Swiss Government. The report includes the following proposal: "In analogy to internal … procedures the creation of settlement procedures should be considered which offer a fresh start to highly indebted countries under defined conditions. The existing rules in the United States for municipalities could serve – with some modifications – as a model. A similar procedure had been applied when dealing with the debts of Indonesia in 1970".[10]
- On 5 April 1990, the Swiss Trade Newspaper[11] publishes a statement by Daniel Kaeser, then Deputy Director of Swiss Finance Administration and later (1992 – 1997) Executive Director at the IMF, proposing international concordat procedures to facilitate debt alleviation.
- On 13 September 1990, the Swiss Coalition of Development Organisations publishes a media release asking for an international debt reduction initiative by Switzerland. The NGOs refer to a letter they had sent some days earlier to the Government submitting two experts'[12] reports and asking for insolvency procedures for highly indebted countries.
- On 18 September 1990, Ulrich Gadient, Member of Parliament (State Chamber), together with 11 other members[13], tables a motion[14] inviting the Swiss Government "to launch a diplomatic initiative for the creation of international insolvency procedures in view of debt alleviation of developing and transition countries being on a reform path".
- On 5 December 1990, the Swiss Government takes a positive view of the proposal and the State Chamber of the Parliament approves it without objections.

Despite these efforts and the parliamentary proposal, the Swiss Government did not become active at the international level.

[9] President: Pierre Languetin, former President of the Swiss National Bank. Members: (1) Robert Holzach, Ex-President of the Swiss Banking Union (SBG/UBS); (2) Franz Muheim, former Member of the Parliament (State chamber); (3) Walter Renschler, Member of Parliament (People's chamber) and President of the Swiss Unions' Association; (4) Stefan Schmidheiny, Industrialist; (5) Richard Gerster, Swiss Coalition of Development Organisations.

[10] Expertengruppe Internationale Verschuldung, Die Schweiz und das Problem der Internationalen Verschuldung, 31. Oktober 1989, pages 10 and 23 (unauthorized translation)

[11] Schweizerische Handels-Zeitung, 5. April 1990, page 2

[12] Kunibert Raffer, University of Vienna; Karl M. Meessen, Universities Augsburg & Geneva

[13] Cavelty, Cottier, Hunziker, Iten, Meier Josi, Onken, Piller, Seiler, Simmen, Uhlmann, Zimmerli

[14] Postulat 90.693