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IMF Board Discusses Possible Features of a New Sovereign Debt Restructuring Mechanism

On September 4, 2002, the Executive Board of the International Monetary Fund (IMF) continued its discussions on the possible features of a new Sovereign Debt Restructuring Mechanism (SDRM), focusing on the treatment of different types of sovereign debts and the design of a sovereign debt dispute resolution forum.[1]

Background

The IMF, as part of its ongoing work on crisis prevention and resolution, has begun a discussion on how to help countries with unsustainable debts resolve them in an orderly manner. Emerging markets have benefited in recent years from the availability of wider sources of finance. However, the diverse nature of the creditor community of bond holders can be troublesome when debt has become unsustainable and has to be restructured.

The Fund is considering two complementary approaches to creating a more orderly and predictable process for sovereign debt restructuring: (i) a contractual approach, in which debt restructurings would be facilitated by enhanced use of certain contractual provisions in sovereign debt contracts and (ii) the establishment of a universal statutory framework which would create a legal framework for collective decision making by debtors and a supermajority of creditors.

Against this background, the Executive Board discussed a paper, "Sovereign Debt Restructuring Mechanism—Further Considerations," that provided a preliminary discussion of two central issues in the design of the SDRM. They are the scope of the debt that the SDRM will cover, and how included claims are organized for voting purposes.

[1] On March 6 and March 8, the Executive Board held an informal seminar to discuss various approaches to improving the legal framework for sovereign debt restructurings. See Press Information Notice No. 02/38, April 1, 2002.

Because creditors of the sovereign have different types of the claims and may not be similarly situated, it would be difficult to aggregate all claims on the sovereign into a single vote. Consequently It would be appropriate to establish a system for classifying claims into classes for voting purposes. The approval of a super-majority of each class would be needed to complete the restructuring. The paper focused specifically on whether to include domestic debt, defined as debt governed by domestic law and subject to the jurisdiction of domestic courts, and official bilateral debt in the SDRM as separate creditor classes, or to exclude these categories of claims from the SDRM. Establishing a statutory SDRM through an international treaty also would allow for creation of a single and exclusive dispute resolution forum that ensures legal uniformity in all jurisdictions and uniform interpretation. The paper provides a discussion of possible features of such a dispute resolution forum.

Executive Board Assessment

At the conclusion of the Board meeting, First Deputy Managing Director Anne Krueger made the following remarks:

"We have had a constructive and thoughtful discussion of possible features of a new Sovereign Debt Restructuring Mechanism focused on the treatment of different types of sovereign debts and a sovereign debt dispute resolution forum. The views expressed today will help shape the development of the mechanism, and provide valuable guidance to the staff for future work. There is broad support among Directors for a statutory debt restructuring mechanism, as well as a development of collective action clauses, to improve the international financial architecture.

"Most Directors reiterated the view that the current process for the restructuring of sovereign debt is more prolonged, more damaging to a debtor and its creditors, and more unpredictable than is desirable. They welcomed the opportunity to give further consideration to a possible mechanism that could provide incentives for a debtor with a clearly unsustainable debt burden, and its creditors, to reach rapid agreement on a restructuring that helps pave the way toward a return to fiscal and balance of payments sustainability. They considered today's discussion, following the earlier one on collective action clauses, to have been a further important step in examining the legal, institutional, and procedural aspects of the two proposed approaches to sovereign debt restructuring.

"Directors observed that debt restructuring is only one element of a comprehensive framework for resolving a member's problems, and that the need for continuing support from the Fund during the restructuring process is important for orderly economic adjustment. Some Directors stressed that care should be taken to ensure that an eventual SDRM does not lead to restructurings that might have been avoided with continued adjustment and more temporary official financing.

Scope of Debt Covered by the Mechanism

"Directors welcomed the opportunity to discuss the complex issues associated with the scope of debts that could be covered by an SDRM, and the ways in which the restructuring of different types of debt could be coordinated.

"Directors agreed that the scope of debts that might need to be included in a restructuring should be sufficiently broad, so as to secure an adequate reduction in the debt and debt-service burden and to achieve sufficient intercreditor equity to garner broad support for a restructuring. They considered that the coverage of individual restructurings would need to be decided by debtors in light, inter alia, of the willingness of the Fund to support a program based upon such a restructuring and the ability to reach agreement with creditors.

"Directors underscored that the potential complexity and diversity of both instruments and creditors highlight the need to allow flexibility in the design of the SDRM. As creditors may have different types of claims on a sovereign and may not be similarly situated, Directors noted that it would be difficult to aggregate all claims on the sovereign for voting purposes into a single vote. Accordingly, Directors indicated that the establishment of a classification system whereby claims are aggregated within—but not across—classes for voting purposes would be appropriate. Directors also noted that such a system could facilitate restructurings by enabling the debtor to offer different terms to different classes of creditors based on the different nature of the claims held by the class in question as well as their particular preferences. The classes should be made sufficiently broad and their number kept to a minimum; the approval of each class would be required to complete the restructuring, giving each class an effective veto over a restructuring done through the SDRM. Most Directors considered that, in order for the SDRM to adapt to the evolution of the capital markets, it might not be desirable to pre-specify all of the classes in the text of the treaty establishing the SDRM. Some Directors noted that the existence of veto power could prolong the debt restructuring process, and suggested that care be taken to ensure that the classification process does not create potential hold-out problems.

"Directors also considered that the mechanism would not necessarily need to encompass all sovereign obligations for it to provide an effective framework for coordinating a comprehensive restructuring. They were in favor of keeping the mechanism simple and tightly confined to addressing specific problems that may cause difficulties for sovereign debt restructuring. In particular, they considered that types of debt that can be restructured without giving rise to severe collective action difficulties could be excluded from the mechanism without jeopardizing the authorities' ability to restructure such claims. They noted though, that it would be important to include those debts for which the SDRM would provide the sovereign with effective tools to overcome collective action difficulties. Directors agreed that sovereign debts governed by foreign law or under the jurisdiction of foreign courts would need to be covered by the mechanism in order to allow the sovereign to use the tools for addressing collective action difficulties.

Domestic Debt

"With regard to domestic debt, Directors emphasized the need for considerable caution in the design of restructurings, particularly with a view to paving the way toward a relatively rapid return by the sovereign to domestic capital markets and preserving at least a core banking system. Directors noted that domestic debt restructuring would also have implications for monetary control, and that a program's reserve floors and monetary targets would play a crucial role in determining the scope of the domestic debt restructuring that would be needed.

"Regarding the treatment of domestic debt under the SDRM, Directors agreed that governing law and the jurisdiction of the claim provided the best basis for distinguishing domestic debt from foreign debt. For sovereign debts governed by domestic law and subject to the jurisdiction of domestic courts, most Directors considered that members already have adequate tools for restructuring such instruments, and that they should be excluded from the SDRM at least initially, though consideration could be given to establishing a procedure that would allow the coverage subsequently to be extended. A few, however, considered that there would be benefits in ensuring that the SDRM is comprehensive, and thought that domestic debt should be included, albeit as a separate class, and that the consequences of policies on the value of credit denominated in local currency be taken into account in any restructuring of external debt. A number of Directors noted that the Fund should avoid encouraging sovereign debtors to use its sovereign powers to unilaterally restructure domestic claims unless an overall restructuring process is in place that has the support of the international community.

Official Bilateral Debt

"Directors reiterated their view that the Paris Club provides an effective and flexible mechanism for restructuring claims of official bilateral creditors and mobilizing support from such creditors for members' adjustment programs. They cautioned that considerable care would be required in addressing relations between the SDRM and the Paris Club in order to preserve the Club's ability to provide early support, while providing the flexibility needed to address intercreditor equity concerns in the more complex cases in which both private and official bilateral creditors have substantial exposure. Some Directors considered that it is premature to form a firm judgment of the treatment of official bilateral debt under the SDRM before they had the opportunity to hear the views of Paris Club and other official bilateral creditors. Some Directors, however, considered that there were substantial benefits in including official bilateral creditors within the SDRM as a separate class. Some Directors also noted that the claims of non-Paris Club bilateral creditors would need to be taken into account in designing the SDRM. Nevertheless, the preliminary view of the Board was that official bilateral claims should be excluded from the SDRM, at least initially, but that close coordination would be needed between Paris Club and SDRM restructurings.

Sovereign Debt Dispute Resolution Forum

"Most Directors recognized that one of the advantages of establishing the SDRM under an international treaty is that it provides a basis for the creation of a single and exclusive dispute resolution forum that would provide for legal uniformity in all jurisdictions and ensure uniform interpretation. At the same time, a few Directors expressed concern that the establishment of a Sovereign Debt Dispute Resolution Forum (SDDRF) could conflict with national laws and face political obstacles in a number of countries.

"Regarding the powers of the SDDRF, Directors agreed that its role should be limited to the administration of claims and the resolution of disputes. Some Directors expressed concern that the creation of creditor classes on a case-by-case basis would likely give rise to disputes whose resolution would require the exercise of considerable discretion by the SDDRF. Directors agreed that the SDDRF should not have authority to challenge decisions made by the Executive Board or to overrule decisions made by the requisite majority of creditors.

"Directors agreed that the relevant rules governing the composition of the SDDRF should be guided by four basic principles: independence, competence, diversity and impartiality. They stressed, in particular, that the SDDRF should not only be independent, but also must be seen to be independent. While Directors felt that it was too early to decide upon the rules that would be put in place to implement these principles, many Directors were of the view that the framework outlined in the staff paper provided a useful basis for further discussion. Some Directors expressed the view, however, that this framework would be unnecessarily cumbersome, or that the procedure outlined for selecting the members of the Forum could raise questions about the independence of the Forum and undermine its legitimacy.

Next Steps

"Directors encouraged management and staff to continue to examine possible design features of an SDRM, and indicated that they would welcome a paper that takes stock of progress on both the statutory and the contractual approaches and discusses how best to move forward by the end of the year. However, a number of Directors stressed that further outreach is needed by the IMF to engage the private sector and emerging market sovereign borrowers in developing a more concrete set of recommendations and to build consensus on the design of the SDRM."

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