

**IMMEDIATE
ATTENTION**

SM/03/101
Revision 1

April 2, 2003

To: Members of the Executive Board

From: The Secretary

Subject: **Statutory Sovereign Debt Restructuring Mechanism—Revised Report
of the Managing Director to the International Monetary and Financial
Committee**

Attached for the **information** of Executive Directors is the revised report of the Managing Director to the International Monetary and Financial Committee on the Statutory Sovereign Debt Restructuring Mechanism.

It is expected that the report will be posted on the Fund's external website following its circulation to the members of the IMFC.

Att: (1)

Other Distribution:
Department Heads

Report of the Managing Director to the International Monetary and Financial Committee on a Statutory Sovereign Debt Restructuring Mechanism

This report responds to the request of the International Monetary and Financial Committee (the IMFC) that the Fund develop, for consideration at the IMFC's meeting in April 2003, a concrete proposal for a statutory sovereign debt restructuring mechanism to be considered by the membership.

The period since the fall 2002 meetings of the IMFC has witnessed a vigorous debate regarding the need for, and design of, a sovereign debt restructuring mechanism (SDRM). It has served to help define the issues, and to build understanding on possible ways to strengthen the international financial system to address the rare cases in which debtors and creditors must confront debt burdens that have become unsustainable. In addition to contributing to the design of the SDRM, the debate has provided fresh impetus to efforts to promote the adoption of collective action clauses in sovereign bonds, as well as proposals for a voluntary Code of Good Conduct. The Fund's work has benefited enormously from extensive dialogue with the private sector, workout professionals, members of the judiciary, academics, representatives of civil society, and the official community.

The constructive work carried out thus far is distilled in the attached Proposed Features of the SDRM. These Proposed Features reflect the result of numerous discussions by the Executive Board and are intended to respond to the IMFC's request for the Fund to develop a concrete proposal for a statutory sovereign debt restructuring mechanism in time for its April 2003 meeting. These Board discussions indicate that most Executive Directors broadly support staff's proposals on the key features of a statutory mechanism that could enhance the operation of the overall crisis resolution framework. Accordingly, the text of the Proposed Features reflects, unless otherwise stated, the current views of most Executive Directors. Of course, further progress on the development of the proposal would require the resolution of a number of additional issues (including those of a more technical nature), some of which are not addressed in the attached text. Moreover, the important question of how the claims of official bilateral creditors would be treated under the SDRM is still an open issue.

Notwithstanding the substantial convergence of views within the Board on the key features of the SDRM, differences remain among Executive Directors on a number of substantive issues. More fundamentally, not all Executive Directors agree on the desirability of a statutory sovereign debt restructuring mechanism. At this stage, there does not appear to be the requisite support among the Fund membership to establish the SDRM through an amendment of the Fund's Articles.

In light of the above, guidance is sought from the IMFC as to the best way to move forward in this area.

Irrespective of the nature of the Fund's future work on the SDRM itself, the Executive Board's discussions have highlighted a range of issues of relevance to any crisis resolution framework that warrant continued work. These include facilitating the coordination between

official bilateral and private creditors, the potential benefits of, and modalities for, aggregation for decision taking by investors, enhancing transparency and disclosure, and carrying forward efforts to promote the inclusion of collective action clauses in new sovereign debt issues. Related issues include a review of the application of the framework on assessing debt sustainability, the elaboration of best approaches to the resolution of systemic banking problems, particularly in the context of the restructuring of sovereign debt, and a review of factors pertaining to a restoration of a member's access to international capital markets.

Proposed Features of a Sovereign Debt Restructuring Mechanism

1. Objectives

The objective of the Sovereign Debt Restructuring Mechanism (SDRM) is to provide a framework that strengthens incentives for a sovereign and its creditors to reach a rapid and collaborative agreement on a restructuring of unsustainable debt in a manner that preserves the economic value of assets and facilitates a return to medium-term viability, thereby reducing the cost of the restructuring process. In order for the SDRM to achieve these objectives, it must be a part of a general effort to strengthen the framework for crisis prevention and resolution, including the policies on lending into arrears and on exceptional access to Fund resources.

2. Principles

The design of the SDRM would be guided by the following principles:

- The mechanism should only be used to restructure debt that is judged to be unsustainable by the debtor. It should neither increase the likelihood of restructuring nor encourage defaults.
- In circumstances where a member's debt is unsustainable, the mechanism should be designed to catalyze a rapid restructuring, both in terms of when it is initiated and, once initiated, when it is completed.
- Any interference with contractual relations should be limited to those measures that are needed to resolve the most important collective action problems.
- The framework should be designed in a manner that promotes greater transparency in the restructuring process.
- The mechanism should encourage early and active creditor participation during the restructuring process.
- The mechanism should not interfere with the sovereignty of debtors.
- The framework should establish incentives for negotiation—not a detailed blue print for restructuring.
- The framework needs to be sufficiently flexible—and simple—to accommodate the operation and evolution of capital markets.

- Since the framework is intended to fill a gap within the existing financial architecture, it should not displace existing statutory frameworks.
- The integrity of the decision making process under the mechanism should be safeguarded by an efficient and impartial dispute resolution process.
- The formal role of the Fund under the SDRM should be limited.

3. Scope of Claims

(a) While the mechanism would identify the scope of claims that could potentially be subject to a restructuring (“eligible claims”), whether all or some of these claims would be restructured in a particular case would be determined by the debtor, in light of negotiations with its creditors.

(b) For purposes of the mechanism, and subject to (c) below, eligible claims would be limited to rights to receive payments from the specified debtor (as defined in the mechanism): (i) that arise from a contract relating to commercial activities of the specified debtor and (ii) that are neither governed by the laws of the member activating the SDRM, nor subject to the exclusive jurisdiction of a tribunal located within the territory of that member. Eligible claims would also include claims for payment of judgments resulting from a right to receive payments under a contract that meets criterion (i) above, if the enforcement of such judgment is sought outside of the territory of the member activating the SDRM.

(c) For purposes of the mechanism, a specified debtor would comprise the central government of the member activating the mechanism and, subject to consent of the debtor in question, could also include (i) the central bank or similar monetary authority of the member and (ii) any local governments or public entities within the territory of the activating member that are not subject to a domestic statutory debt restructuring framework.

(d) Notwithstanding the above, eligible claims would exclude:

- (i) Claims that benefit from a statutory, judicial or contractual privilege, to the extent of the value of such a privilege unless such a privilege: (i) was created after activation and (ii) arises from legal enforcement proceedings against a specified debtor;
- (ii) Guarantees or sureties, unless the underlying claim benefiting from such a guarantee or surety is in default;
- (iii) Wages, salaries and pensions;
- (iv) Contingent claims that are not due and payable, unless such contingent claim possesses a market value;

- (v) Claims held by international organizations that are specified in the amendment.¹ (The amendment would authorize the Board of Governors, by an eighty-five percent majority of the total voting power, to amend the initial list of such organizations and claims); and

[(vi) Claims held by foreign governments or qualified governmental agencies]²

4. Activation

Consistent with the principle of sovereignty, the mechanism could only be activated at the initiative of the member whose debt is to be restructured. When activating the mechanism, the member would represent that the debt to be restructured was unsustainable. For purposes of the legal effectiveness of activation, this representation would not be subject to challenge.

5. Provision of information

Upon activation, a procedure would unfold that would require the activating member to provide all information regarding its indebtedness and the indebtedness of all specified debtors (including debt that will not be restructured under the SDRM) to the Dispute Resolution Forum (DRF). The activating member would be expected to present the following information:

- (i) a list of claims for which restructuring is sought under the SDRM (“SDRM Restructuring List”);
- (ii) a list of claims for which restructuring is sought outside of the SDRM (“Non-SDRM Restructuring List”); and
- (iii) a list of claims for which no restructuring is sought.

Such information shall be published by the DRF. Upon notification to the DRF, a debtor may also modify these lists during the restructuring process.

6. Registration and Verification of Claims

Once the activating member provides the above-mentioned information, a registration and verification process would take place that would enable creditors to be in a position to vote on an aggregated basis for each specified debtor. Only those creditors whose claims are

¹ If this approach is followed, the modalities for restructuring the eligible claims of international organizations that are not on the exclusion list would also need to be addressed.

² Pending outcome on discussions regarding the treatment of official bilateral claims under the SDRM.

included on a SDRM Restructuring List and who wish to participate in the voting would have to register. Creditors whose claims are on a SDRM Restructuring List, but who fail to register within the specified period would not be entitled to vote, but their claims would be restructured on the terms approved by the required majority of holders of verified claims (“verified claims”). Claims would be considered verified unless challenged. The DRF would have the responsibility for adopting rules regarding the registration and verification process, with the objective of safeguarding the overall integrity and transparency of the process on the one hand, and preserving asset values through a timely process, on the other hand.

7. Limits on Creditor Enforcement

(a) When, after the date of activation but prior to the certification of a restructuring agreement, a holder of a claim that appears on a SDRM restructuring list has recovered amounts due on the claim through legal proceedings (enforcing creditor), the claim of the enforcing creditor shall be restructured as follows: (i) first, the percentage of reduction offered to all other claims in the same class will be calculated with respect to the claim of the enforcing creditors on the basis of the value of the claim at the time of activation (the notional restructured amount); and (ii) second, the amount recovered through post-activation legal proceedings shall be deducted from the notional restructured amount.

(b) Upon the request of an activating member and the approval by creditors holding 75 percent of the outstanding principal of verified claims on a specified debtor, a temporary suspension (stay) would become effective for all enforcement proceedings brought by creditors holding claims on a SDRM Restructuring List involving that specified debtor or its assets. The period of the suspension would be as requested by the activating member and approved by the creditors.

(c) Upon the request of an activating member and, upon the approval of holders of verified claims on a specified debtor, the DRF will issue an order to suspend particular enforcement proceedings against a specified debtor or its assets brought by creditors holding claims on a SDRM restructuring list if, in the assessment of the DRF, the proceeding has the potential to undermine a SDRM restructuring; Prior to the completion of the registration and verification process, creditor approval will be evidenced by approval of a representative creditors’ committee; thereafter, the issuance of any new order or the continued effectiveness of an existing order will require the approval of creditors holding 75 percent of outstanding principal of verified claims.

Although the approach set forth in Section 7 is supported by many Executive Directors, a number of Executive Directors are of the view that a general cessation of payments and a temporary automatic stay should be a feature of the mechanism.

8. Creditor Committees

As a means of encouraging active and early creditor participation in the restructuring process, a representative creditors' committee, if formed, would be given a role under the SDRM to address both debtor-creditor and inter-creditor issues. Consistent with best practices in this area, the debtor would bear the reasonable costs associated with the operation of these committees. The DRF would have the authority to review these costs and limit the amount recoverable from the debtor where they appear to be excessive.

Although the approach set forth in Section 8 is supported by many Directors, some Directors expressed the view that costs of creditors' committees should be borne equally between the debtor and its creditors.

9. General Voting Rules

Subject to Section 11 below³, creditor approval of proposals made by a specified debtor regarding: (i) a stay on enforcement, (ii) priority financing; and (iii) the terms of a restructuring agreement would be made by creditors holding 75 percent of the outstanding principal of verified claims. Holders of verified claims who are under the control of a debtor shall not be entitled to vote.

10. Priority Financing

As a means of inducing new financing, the SDRM would provide that a specified post-activation financing transaction could be excluded from the restructuring if the extension of such financing is approved by creditors 75 percent of outstanding principal of verified claims. Where such a decision has been taken, the DRF would be precluded from certifying an agreement that restructured such excluded financing absent the consent of the creditor that had extended the financing in question.

11. Restructuring Agreement

(a) When a specified debtor proposes a restructuring agreement, it would also be required to provide information to the DRF as to how it has treated or how it intends to treat claims that are not to be restructured under the SDRM, thereby enabling holders of verified claims to make a decision regarding the sovereign's proposal with the full knowledge of the treatment of other claims.

³ If official bilateral claims are included under the SDRM, they would also vote as a separate class for purposes of a stay on enforcement and priority financing.

(b) Holders of verified claims would be requested to vote on a proposed restructuring agreement, except for holders of unimpaired claims. For purposes of the mechanism, a creditor would be considered unimpaired if the restructuring of the creditor's claim was limited to a reversal of any acceleration of the claims in question, provides for the immediate payment of all outstanding interest, and no other default is continuing. Any such unimpaired claim will be deemed to be reinstated despite activation of the SDRM. A separate restructuring agreement would be proposed for each specified debtor. Once certified by the DRF, an agreement would become binding with respect to all registered claims and all claims that appeared on an SDRM Restructuring List but were not registered. Subject to the classification rules below, all holders of eligible claims would have to be offered the same restructuring terms or the same menu of terms.

(c) If official bilateral claims are included under the SDRM, separate classification of these claims would be required.

(d) As a means of facilitating a restructuring agreement amongst creditors with different preferences, a debtor would have the option—but not the obligation—of creating different classes of registered claims. In such cases, holders of claims in different classes could be offered different terms. The approval of 75 percent of outstanding principal of verified claims in each class would be a condition for the effectiveness of the overall agreement. Classification could not be used in a manner that would result in the discriminatory treatment of similarly situated creditors.

12. Termination

The SDRM procedure would terminate:

- (i) automatically upon the certification of all restructuring agreements by the DRF;
- (ii) by notice of termination given by the central government of the member that had activated the mechanism; or
- (iii) by an affirmative vote of creditors holding 40 percent of the outstanding principal of verified claims (after completion of the registration and verification process),

13. Dispute Resolution Forum

(a) The DRF would be established and organized in a manner that ensures independence, competence, diversity and impartiality. The DRF, whose operations would be financed by the Fund, would be established and organized as follows:

- (i) First, upon the advice of international organizations (such as UNCITRAL) and professional associations with expertise in insolvency and debt restructuring matters, the Managing Director would designate a selection panel of 7-11 highly qualified judges or private practitioners.

- (ii) Second, the selection panel would be charged with identifying 12-16 candidates that would constitute the pool from which the DRF panel would be selected when a crisis arises. Although the amendment would specify the qualification criteria (e.g., judicial experience in debt restructuring matters), the nomination process would be an open one. Once selected, this pool would be approved by the Board of Governors by an “up or down” vote. Except for the President of the DRF, all of members of the pool would continue to work in their other capacities until impaneled.
- (iii) Third, when the SDRM is activated, four members of the pool would be impaneled by the President of the DRF. One of these members would be responsible for making initial determinations. The remaining three members would constitute an appeals panel.

(b) The responsibilities of the DRF would be limited. It would have no authority to challenge decisions of the Executive Board or make determinations on issues relating to the sustainability of a member’s debt. Its primary functions are summarized as follows:

- (i) Administrative Functions – this would include notification to creditors, registration of claims and the administration of the verification and voting process. It would also include the certification of decisions taken by the requisite majority of creditors.
- (ii) Dispute Resolution – the DRF would be charged with resolving disputes that will arise during the SDRM restructuring process and would have exclusive jurisdiction over such disputes during this period. In performing this function, the DRF will be reactive: it will not initiate investigations regarding potential issues, but will merely adjudicate disputes brought by a party. While it could request the parties to provide evidence, the DRF would have no subpoena power.
- (iii) Suspending enforcement – Upon the request of the debtor and upon the approval by creditors or their representatives, the DRF may issue an order that will enjoin specific enforcement actions during the restructuring process when it determines that such enforcement actions could seriously undermine the restructuring process.

(c) In order to discharge the above responsibilities, the DRF would have the power to issue rules and regulations, which would enter into force unless overruled by the Board of Governors, by an eighty-five percent majority of the total voting power, within a specified period.

14. Legal Basis of the SDRM and its Consistency with Domestic Laws

The SDRM and the DRF could be established through an amendment of the Fund's Articles, which requires acceptance by three-fifths of the members, having eighty-five percent of the total voting power. Since the amendment will involve the establishment of new treaty obligations that will affect the rights of private parties under domestic legal systems, most countries will need to adopt legislation for acceptance of an amendment or for making the new provisions effective under their internal law. It is for each member to determine the extent to which the adoption of the SDRM would require changes in its domestic laws.