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IMF Board Discusses Possible Features of A Sovereign Debt Restructuring Mechanism

On March 14, 2003, the Executive Board of the International Monetary Fund (IMF) continued its discussions on the possible features of a new Sovereign Debt Restructuring Mechanism (SDRM).

Background

As part of its ongoing work on crisis prevention and resolution, the IMF has been discussing how to help countries with unsustainable debt burdens. Emerging markets have benefited in recent years from the availability of wider sources of financing. However, the diverse nature of the creditor community of bond holders can be problematic when debt has become unsustainable and has to be restructured.

In September 2002, the International Monetary and Financial Committee (IMFC), which represents the interests of the IMF's 184 member countries, endorsed the Fund's work on crisis prevention and its efforts to create a framework for an equitable debt restructuring that restores sustainability without including incentives that unintentionally increase the risk of default. The IMFC requested the IMF to develop a concrete Sovereign Debt Restructuring Mechanism (SDRM) proposal for consideration at the IMFC's next meeting scheduled for April 12, 2003.

The Executive Board of the IMF had held a series of informal discussions in the lead up to the IMFC meeting last September. The Board discussion in December 2002 was the first detailed review of issues associated with a possible design of a SDRM.[1] The Board's discussion on March 14, 2003 based on the staff paper "Proposed Features of a Sovereign Debt

[1] The discussion revolved around a staff paper, "The Design of the Sovereign Debt Restructuring Mechanism - Further Considerations," which provides a comprehensive review of the principal features of a possible statutory approach. A summary of that discussion is contained in Public Information Notice No. 03/06.

Restructuring Mechanism", further advanced the issue. This paper reflects the convergence of views that has taken place within the Board on a number of issues, and contains a first draft of the Proposed Features of an SDRM. The formulation of these proposals involved an extensive dialogue with private market participants, debt-restructuring practitioners and other workout specialists, academics, and members of the official community, and benefited from inputs received during a workshop and conference organized at the Fund in January 2003.

Executive Board Assessment

Directors welcomed the opportunity to continue their discussion of the proposed features of a SDRM and to comment on a first draft of the "Proposed Features", in line with the request by the IMFC for a concrete proposal for its April 2003 meeting. They also took stock of recent progress on other elements of the broader framework for crisis resolution, and considered a number of specific issues of a sovereign debt restructuring mechanism that had not been addressed or resolved during previous meetings.

Directors generally recognized that the extensive analysis and consultation undertaken in the course of the development of the proposals over the past year, including through the recent SDRM workshop and conference, have considerably advanced the understanding of the issues to be addressed to achieve more orderly sovereign debt restructurings. While most Directors support the establishment of a SDRM, our discussions have also confirmed that not all Directors are convinced of the need for, or the desirability of, such a mechanism. Moreover, views among Directors that support a SDRM continue to differ on a number of design issues. In any such mechanism, it will be important to continue to aim at striking the right balance between limiting the interference with contractual relations to what is strictly needed and establishing an incentive structure that effectively helps to preserve the value of assets and a credit culture for the future.

Directors welcomed the progress being made on tools for improving the process of sovereign debt restructuring that could complement the SDRM, in particular the recent decision of the Mexican authorities to include collective action clauses (CACs) in Mexico's new international bond issues. They hoped that this would contribute to the broader use of CACs in jurisdictions where this is not yet the norm. Directors also welcomed the initiative among the private sector and the official community to formulate a voluntary Code of Conduct that would establish expectations regarding relations between a debtor and its creditors and among creditors. Most Directors recognized that a voluntary Code of Conduct, while valuable on its own merits, could also be a useful complement to the SDRM, identifying best practices and introducing some predictability in debtor-creditor relations. To be effective, a Code would need to be able to attract broad support among debtors and their creditors, and it would therefore be important that it be developed jointly by debtors and their creditors, while involving other key stakeholders. Directors also stressed, however, that, given its voluntary nature, a Code of Conduct could not resolve collective action difficulties. Accordingly, a Code can be complementary to, and not a substitute for, CACs and/or the SDRM.

Among the Directors that expressed support for a SDRM, the general view was that the Proposed Features represent a balanced response to key questions, although a number of issues remain open. These Directors broadly agreed with the proposed definition of claims eligible for debt restructuring. They agreed that the text of the amendment to the Fund's

Articles should list the international organizations whose claims would be excluded from the SDRM but also provide that this list could be modified by a decision of the Board of Governors by 85 percent of the total voting power. They also agreed to include judgment claims in the claims eligible for restructuring, as well as privileged claims where the privilege is created through legal enforcement proceedings after activation of the SDRM. Directors looked forward to the outcome of the discussions between the staff and the Paris Club Secretariat on coordination issues with respect to private and official bilateral creditors. This should help determine how best to handle official bilateral creditor claims in the SDRM context.

Most Directors reiterated the view that the sovereign debtor should be able to activate the SDRM unilaterally, without third party confirmation that the activation is justified. In light of this, many Directors did not support the suggestion that the debtor bear the costs of the operation of the mechanism in circumstances where the Fund determines that activation was unjustified. Moreover, these Directors noted that the potential for unjustified activation is low because of the costs associated with a sovereign default. A number of Directors, however, saw merit in a rule enabling the Fund to recoup administrative costs from the debtor, as a disincentive for inappropriate activation.

Many Directors recognized that, consistent with international best practice, the debtor should bear the reasonable costs associated with the operation of representative creditor committees. Some Directors, however, were of the view that the costs should be borne equally between the debtor and its creditors.

Directors continued their discussion from last December on how best to contain risks of potentially disruptive creditor enforcement once the SDRM is activated. While circumstances may arise in which a general cessation of payments may be unavoidable, many Directors recognized that, in the sovereign context, a member may need to continue to service certain claims so as to limit economic dislocation. Moreover, a sovereign may wish to continue to service claims that it intends to restructure. Accordingly, many Directors expressed the view that it would not be appropriate for the SDRM to be designed in a manner that assumed that the sovereign would effect a general cessation of payments in all cases, and—in the absence of such a cessation—it would not be appropriate to include in the SDRM a general stay on enforcement that would be triggered automatically upon activation.

In light of this, Directors discussed the merits of developing a set of alternative measures that would prevent enforcement actions from disrupting the negotiation process and from delaying the conclusion of an equitable restructuring agreement. Many Directors indicated that they were willing to support an approach that would combine the following features: (i) a "hotchpot" rule designed to offset the advantage received by a litigating creditor collecting on a court judgment prior to conclusion of the restructuring agreement; (ii) upon the request of the sovereign debtor, a general stay on enforcement approved by creditors holding 75 percent of verified claims, it being understood that such stay would apply to all enforcement actions by creditors whose claims are on the SDRM Restructuring List; and (iii) upon request of the sovereign debtor, a targeted stay on enforcement approved by a representative creditors' committee (or when the verification process has been completed, approved by creditors holding a 75 percent majority of verified claims); this stay would be effected by the issuing of an order by the Dispute Resolution Forum (DRF) to suspend a particular legal action where, in

the assessment of the DRF, the targeted action has the potential to undermine the SDRM restructuring.

A number of Directors continued to be of the view, however, that a broad-based cessation of payments combined with a temporary, automatic stay on enforcement should be a feature of the mechanism. These Directors noted that a general standstill and stay would be the most effective safeguard against pre-agreement litigation. Moreover, an automatic stay could enhance the transparency and predictability of the restructuring process, while better serving inter-creditor equity. In light of this, these Directors asked that the merits of an automatic stay continue to be carefully explored, possibly coupled with a provision that would make it easier for creditors to terminate the mechanism.

The discussion indicated that, on other aspects of the SDRM, the Proposed Features appear to have generally well captured the sense of the Board during previous discussions, although on a number of points diverging views continue to be held, and a number of technical issues remain to be worked out. This includes a call by a few Directors for greater clarity on the criteria for determining that a creditor is under the control of the debtor, for the purposes of excluding that creditor's vote. On a particular point that remained to be resolved, most Directors supported the proposal that a 40 percent voting threshold be established for a creditor vote on termination of an activated SDRM.

Directors also had a further discussion on aspects related to the proposed DRF, which, most Directors agreed, would be an essential—albeit strictly circumscribed—feature of a SDRM. These Directors agreed that the DRF should have authority to promulgate rules with respect to claims administration and dispute resolution procedures and that such rules would become effective unless overruled by a decision of the Board of Governors by 85 percent of the total voting power. Some Directors emphasized the importance of national diversity as a selection criterion for DRF members. However, a few Directors continued to be of the view that the DRF was not necessary. Moreover, a few Directors remained unconvinced that an amendment of the Fund's Articles of Agreement would be the most appropriate vehicle for the establishment of the SDRM.

Our discussion has been useful in further clarifying some of the operational issues of a SDRM. Nevertheless, Directors recognized that a range of issues need to be resolved. The report to the IMFC on the work on the SDRM and other aspects of crisis resolution will allow the Committee to give guidance on the best way of moving forward in this area.