NEW DEVELOPMENTS IN SOVEREIGN DEBT RESTRUCTURING

1350 New York Ave., N.W, Enrique V. Iglesias Conference Center, Washington, DC, Conference Room CR2

AGENDA

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Tuesday, April 16th, 2013

9:30 – 9.45am	**Welcome Remarks** Jose Juan Ruiz, IDB

9:45 – 11:15am **Panel 1. When do and when should countries restructure their debts?**

There have been about 190 debt exchanges since 1950. Is this too many or too few? Have countries restructured debts in a timely manner or have they delayed too much? Have delays been costly, are they avoidable? What has led countries to these difficult decisions? What have been the costs and what have been the benefits of debt restructuring? As the majority of cases have not led to protracted legal problems, can we conclude that the current system is working? Has debt restructuring solved the underlying economic problems in the countries concerned? Do answers to these questions suggest ways to improve the current system for debt restructuring?

Chair:	Edward Bartholomew, IDB
Lead speakers:	Varapat Chensavasdijai, IMF Sudarshan Gooptu, World Bank Andrew Powell, IDB
Discussant:	Guido Sandleris, Universidad Torcuato di Tella Ugo Panizza, Graduate Institute, Geneva

11:15 – 11:30am	**Coffee**

11:30 – 1:00pm **Panel 2. Recent Developments in Sovereign Debt Restructuring**

What are the consequences of the recent decisions of the New York District and Appeals courts for Argentina and for countries that may restructure their debts in the future? Will these decisions give greater power to creditors? Will they make it more difficult for countries to pursue a successful restructuring with few holdouts? Do collective action clauses make these recent decisions largely irrelevant? In the face of these decisions, is there any new advice to be given to countries that are considering restructuring bonds that have or that do not have collective action clauses? What advice should be given to countries issuing new bonds regarding clauses to include? Will these decisions negatively affect New York as a market for sovereign bond issuance? Will the redefinition of the pari-passu clause change the position of multilaterals that enjoy preferred creditor status?

Chair:	John Williamson
Speakers:	**Banks and Sovereigns: The Role of Official External Lenders** Otto Heinz, ECB **Policies to Avoid Contagion: Is a Vienna Type Initiative the Answer?** Alex Pivovarsky, EBRD **Do Recent Cases Imply an End to Debt Restructuring Without Creditor Litigation?** Cathleen McLaughlin, Allen and Overy **Do CAC's + Aggregation Allow for Smooth Restructurings? If Not, Why Not?** Anna Gelpern, American University

1:00 – 2.15pm	**Buffet Working Lunch** **Moderator: Jose Juan Ruiz, General Manager and Chief Economist, IDB** **Speaker: Martin Wolf, Financial Times** **"Solving the European Crisis: Lessons for Sovereign Debt and Banking Problems"**
2:30 – 3.45	**Panel 3. Ideas to Improve Sovereign Debt Contracts**

Sovereign bond contracts come in various shapes and sizes. There are many different pari-passu clauses, collective action clauses have been written in different ways as have exit consents. Recent developments in New York and London courts will no doubt affect how future bond contracts are written and a model collective action clause has now been agreed within Europe. Is there a case for a more standardized sovereign bond contract for emerging economies? If so what would such a contract look like? Would standardization limit beneficial innovation? Would it be useful to include standstill provisions within bond contracts? What other innovations are worth considering?

Chair:	Jorge Alers, General Council, IDB
Speakers:	Deborah Nache-Zandstra, Clifford Chance, London
	Lee Buchheit, Clearly Gottlieb, NY
	Leland (Lee) Goss, ICMA
3:45 – 4:00	**Coffee Break**
4:00 – 5:30	**Panel 4: Ideas to Enhance Institutions for more Efficient Restructuring**

How can the current system for debt restructuring be improved? Do the recent legal actions and decisions in New York affect the case for a more institutionalized system for countries to restructure their debts? What would be the advantages of such a system? Would it lead to better outcomes for creditors and borrowers or would it favor one of these groups? Would such a system require a Treaty between countries or could it be implemented in a more limited fashion? What would the role of the IMF and other multilaterals be? Is there a case to invent new institutions?

Chair:	Jim Haley
Speakers:	Benu Schneider, UN
	Sean Hagan, IMF
	Christophe Paulus, University of Berlin
	Jose Antonio Ocampo, Columbia University
	Hans Humes, Greylock Capital Management
5:30 – 5:45	**Closing remarks.**

New Developments in Sovereign Debt Restructuring: Summary

Organized jointly by the Inter-American Development Bank (IDB) and the UN Department of Economic and Social Affairs and held at the IDB in Washington DC on April 18th 2013 under Chatham House Rules.

Executive Summary

Four panels were organized in this one day workshop covering topics such as, when do, and when should, countries restructure their debts; recent developments in sovereign debt restructuring; potential innovations to debt contracts; and possible changes in institutions to improve how debts are restructured. Participants were drawn from the private sector, from country authorities, from official organizations and from academia, many with practical hands-on experience of debt restructuring, many with an economics and many with a legal background.

While there were a range of opinions, many participants in the room agreed with the notion that the current system for debt restructuring is not perfect and could be improved. Several participants noted that the costs of default and restructuring can be excessive and that there are deadweight costs or inefficiencies; or in other words that the costs to borrowers could be reduced without affecting the return, or perhaps even increasing the return, to creditors. There was in the words of one speaker too much pain for too little gain. In particular it was noted that there are often substantial delays before countries decide to default and between default and restructuring and that delays are generally costly, and that some of those delays may be attributable to the current system for restructuring. It was argued that countries appear to face a choice of either a relatively light restructuring with no principal haircut and a low present value haircut, or a deeper restructuring that may then face greater uncertainty and potentially long and complex legal problems. A bimodal distribution of haircuts with frequent multiple restructurings was noted as outcomes of this choice.

If anything, recent developments in New York courts may have exacerbated this situation. While opinion differed on the wider implications of the NML vs. Argentina case, there appeared to be a general view that it will likely increase uncertainty for countries that may need to restructure debts and may give greater power to hold-outs. The New York courts were in the words of one participant "bedazzled and bewitched" by the Parri Pasu clause and we have moved from a situation where no-one knew what the clause meant to a meaning that no-one thought it meant. Collective Action Clauses (CAC's) were seen as only a partial answer to this situation as hold outs may gain blocking positions even if CAC's include aggregation clauses and they do not cover all classes of creditors. It was noted that we may not know the implications of the case for *many years until the rulings are re-tested, and we may not know which borrowers will decide not to restructure or to postpone restructurings further given the decisions made.*

Several innovations to contracts were discussed including work in progress regarding standardizing CAC's with aggregation and new Parri Pasu clauses. Both the costs and benefits of standardization were detailed. Other innovations, such as adding standstill clauses and sovereign coco's were also explained and their merits analyzed. Finally there was considerable interest in considering contingent debt instruments such as GDP indexed debt as a way to reduce the need for restructurings ex ante. Participants noted the benefits and the hurdles for the wider use of such instruments.

Finally several potential institutional changes were discussed that ranged from a forum between a borrowing country and all creditor classes, to enhance information exchange and coordination, to a more statutory approach with a bankruptcy-type proceeding with several mixed or intermediate proposals. The pros and cons of several of the arrangements proposed were noted, highlighting a set of intricate trade-offs. The role of the IMF within each arrangement was also highlighted as an important factor and the need to allow the IMF to act as a lender of last resort when required, but at the same time to protect against potential moral hazard.

It was noted that there appears to be little political will to make significant institutional changes at the current time, and that perhaps more emphasis should be placed on contractual innovations. It was also noted however that political will is endogenous to the context and that for example if the implications of NML vs. Argentina are seen as wider rather than narrower this might conceivably change over time.

Panel by Panel Summaries

Panel 1: When Do and When Should Countries Restructure their Debts?

The decision to default and to restructure debt was seen as a particularly difficult one that countries should only seek as a last resort and when the costs of an unsustainable debt burden outweigh the costs of default and restructuring. It was argued that while the specific costs of default are hard to measure they are likely very significant indeed. The general view expressed was that costs may be excessive in the sense that there are costs that are unnecessary to maintain borrower discipline: there is too much pain for too little gain. This implies that improvements in the international architecture that reduce these deadweight costs may lead to efficiency gains that can then be shared between borrowers and lenders.

A further discussion ensued regarding whether restructurings actually solve the underlying problems. It was noted that countries often leave default with higher debt ratios than when they enter default and that a high proportion of countries have undergone multiple restructurings. While it cannot necessarily be argued that this latter point implies an inefficiency it does suggest that current debt contracts do not share risks effectively. One interpretation is that creditors maintain borrowers on a short leash giving only low present value haircuts increasing the likelihood that borrowers may need to restructure.

This is consistent with another finding, that the distribution of haircuts is bimodal. Most present value haircuts are small (and most with small present value haircuts have a zero principal haircut) but some have much deeper present value haircuts (with principal haircuts) and these are very few in between. It was pointed out that there is no reason to believe that the fundamental problems of countries would have such an abnormal distribution and hence this feature is likely a result of debt restructuring mechanisms than the underlying challenges facing countries.

It was posited that countries that decide to restructure may face a choice: either do so relatively quickly with no principal haircut and a low present value haircut and attempt to avoid legal difficulties or go for a deeper present value restructuring with a principal haircut and face potential legal challenges. Given current legal uncertainties, many countries that might actually need a deeper haircut may opt for the first route, increasing the chances of facing further restructurings down the road to avoid potential legal challenges in the future.

Another finding, namely that delay (the time between default and restructurings) and haircuts are positively correlated was also noted. Indeed in many cases delays of several years occur. In fact there are various interpretations of this relationship. One is that countries that need deeper haircuts delay restructurings as the mechanisms for restructuring in such cases are complex and/or fraught with potential legal problems. A second is that delay actually worsens the situation so that the haircut that is eventually required is deeper. If either interpretation is true then it suggests that if restructuring mechanisms could be improved, this may result in efficiency gains.

Finally there was a more detailed discussion regarding the costs of default. The specific sources of the costs of default included growth foregone, financial crises, and negative effects on trade, FDI and the supply of credit to the private sector. It was argued that default costs rise with delay, both before default and between default and restricting. Political costs were also mentioned and the cost that governments may be tempted to “gamble for redemption” or in other words adopt risky policies that have a small chance of succeeding (and so the country escaping default) but which if they do not succeed then the default costs are much higher. It was therefore suggested that the focus on how to improve the international architecture might consider how to limit delay and how to limit specific deadweight costs such as financial crises and gambling for resurrection that are likely to hurt both borrowers and creditors alike.

Panel 2: Recent Developments in Sovereign Debt Restructuring

The second panel focused on recent developments in sovereign debt restructuring. It was pointed out that sovereign debt exists within a fundamental legal tension: on the one hand it is unenforceable (creditors cannot normally attach debtors' assets) but on the other hand it is inescapable as debtors will never be able to escape all of its creditors. This tension has given rise to clauses in bond contracts such as the Pari Passu clause and Collective Action Clauses (CAC's). But tensions remain and as recent events have proven the tensions are evolving, and can certainly not be considered to have been "resolved".

The recent Greek case was one of the topics debated and the lack of an institutional framework within the Eurozone was noted as one of the underlying problems. Given the lack of ex ante formal mechanisms, the ECB launched a set of emergency support programs. A lesson learned is that more formal mechanisms are needed to decide when and how emergency liquidity provision would be provided and to provide greater coordination between different agencies.

The Vienna Initiative, a framework for safeguarding financial stability in emerging Europe after the global financial crisis in 2008/09, was precisely an example of a coordinating device, in this case among international banks and Governments. However, it was highlighted that this was an ad-hoc solution to a specific problem and it may not have universal relevance. It was argued that it worked well where the crises were one of liquidity and not of fundamental insolvency. In that sense it was suggested it may not be a useful analogy for resolving sovereign debt restructuring, where by definition a solvency problem was present and much of the argument revolves around burden sharing or how to allocate losses.

The recent developments regarding the NML vs. Argentina case were also discussed and the recent decisions and implications of the New York District and Appeals courts. The New York court was said to have been "bewitched and bedazzled" by the Pari Passu clause, and that the reinterpretation was quite extraordinary. The reinterpretation was described as that the world has gone from a clause that no-one really knew what it meant to a meaning that no-one thought it meant. Having said that it was pointed out that Italy has bonds that explicitly states that their Pari Passu clauses refer to ratable payments as opposed to ranking – in line with the decisions of New York. One "solution" discussed was that in new bonds an altered and possibly standardized Pari Passu clause would now be adopted, although it was also pointed out that standardization may be problematic and preclude sometimes valuable innovation.

It was noted that CAC's should not be thought of as a solution to the reinterpretation of the Pari Passu clause, since they target different things. Parri pasu clauses relate to treatments of different liabilities while CAC's refer to percentages of the owners of the same liability. While in some cases CAC's will help, particularly CAC's with aggregation clauses, bondholders can attempt to obtain blocking positions, even if aggregation clauses across some issues are included. Moreover, CAC's do not cover all classes of creditors, so in the future we may see more tests involving other creditor groups.

There remains much doubt on how wide the implications of NML vs. Argentina will be. One view is that it will not have significant consequences and it is more about the actions of one particular borrower. However, this view may not take into account the changes in behavior that may well arise. In the first place, increased uncertainty may already be having effects on countries pushing them to greater fiscal adjustment rather than to restructuring, or to choosing lighter restructurings in the hope of avoiding legal problems. In the second place, it may make hold outs much more aggressive than they have been to date. The reinterpretation of Parri Pasu may then reinforce the bimodal distribution of haircuts mentioned above.

Panel 3: Ideas to Improve Sovereign Debt Contracts

The focus of Panel 3 was on potential improvements in contractual technology. Participants agreed that further improvements should be made and noted that there is considerable ongoing work.

One discussion focused on the standardization in contracts. The Euro Area has already moved towards adopting standardized, mandatory CAC's, but the International Capital Market Association (ICMA) is in its own process of revising a model CAC and is also considering developing a standardized model for Pari Passu clause. There may then be a trend towards standardization but participants noted that there are costs as well as benefits to this process. History is replete of examples of errors and unintended consequences of issues in drafting and while standardization may reduce the likelihood of such mistakes it would increase their costs. Standardization may though improve information and understanding and ultimately liquidity but may also limit innovation that can be beneficial.

Introducing contractual standstill clauses in debt contracts were also analyzed by participants. It was thought that their introduction may reduce delays by sovereigns in confronting problems of unsustainability. It was noted that they should be sufficiently flexible and should be considered as an additional tool to restructuring. A problem with such provisions is the specification of the trigger. The simplest might be an automatic trigger point, such as the Debt to GDP ratio, but it was also pointed out that simple triggers do not correlate well to unsustainability, which is a very complex concept for a sovereign. Further analysis of how contractual standstill or other clauses (such as the analogy to contingent capital type contracts now used for banks – i.e.: a sovereign coco clause) would work, they costs and benefits and of investor appetite was recommended. Other contractual ideas arose, such as a wider use of trustees to promote enforcement by a single entity, strengthen sovereign immunity provisions in times of crisis or an expansion of bond-holder committee provision.

A question raised was who should be in charge of the implementation of any new contractual technology? Experience has shown that it is better to manage this situation through a group of experts from both creditors and debtors rather than through industry groups who are normally representing one of the sides. However, the official sector has yet to encourage sovereigns to use such modalities to attempt to improve contracts.

Finally, there remains considerable interest in other contractual innovations, particularly in employing GDP indexed debt as a way to share risks. These instruments share risks ex ante and hence may reduce the need for debt restructurings. While they may have strong benefits in managing risks there are several hurdles to their acceptance and use that were discussed. One revolved around the credibility of data, although it was pointed out that unlike inflation Governments do not have the incentive to reduce growth figures. Indeed while the quality of Argentine inflation statistics has been questioned by the IMF, if anything private analysts consider that Argentina is over stated growth and not understated growth, implying larger and not smaller payments on its GDP indexed instruments. A further issue discussed was regulatory as from an investors' viewpoint this may create mismatches on investors' balance sheets and investors' regulators may then require high capital requirements. The trade-off between lower default risk, and a potential mismatch in flows non-default states is one that needs more careful analysis.

Panel 4: Ideas to Enhance Institutions for more Efficient Restructuring

Following on from the first panels, in this session a number of proposals for institutional changes were discussed that it was thought might reduce deadweight losses and improve the efficiency of debt restructuring. These changes ranged from a safe environment for discussion and negotiation to a more statuary approach, where in the last instance there might be a judicial process with enforcement powers.

Participants suggested that a new framework could aim to close several gaps in the current architecture: including a lack of a centralized dispute resolution mechanism, a lack of organized representation of all stakeholders, and a lack of enforceable priority rules for creditors. It was suggested that these gaps contribute to uncertainty and delays and imply higher costs. A more rule-based system might allow the IMF to be a more complete lender of last resort, but with less discretion over cases where solvency problems were present.

A number of mechanisms were also discussed including increasing information on debt stocks and flows through establishing an international registry of debt; the implementation and specific rules on stand-stills and regulatory, tax and accounting treatments that may currently interact to make debt write downs overly costly. Another idea discussed was the creation of a Sovereign

Debt Forum: an organization with a permanent and neutral staff, whose aim would be to design a collective process to enhance sovereign debt as an asset class.

One of the more statuary approaches proposed consisted of three stages: the first one involving voluntary negotiation between the parts, the second one a mediation following the WTO process and the third one being a judiciary ruling whose solution is binding.

Another mechanism proposed was that named a Resolvency Proceedure. The first step of this mechanism consists of a Resolvency clause: a contractual clause which permits the sovereign to commence a resolvency proceedure if it reaches an insolvency state. The second step would then be a resolvency court led by a permanent president and a limited pool of potential judges who would act if appointed for a particular case. The third step would consist of a set the rules governing the procedures. This system would then mix contractual innovations with a more statutory approach.

It was pointed out that there appears to be little political will to consider a more statuary approach at the current time and that it might be better to focus on contractual innovations. However it was also noted that political will is endogenous to the context. And in this sense, the recent developments in the NML vs. Argentina case in New York may be important. If this case is seen to have wider rather than narrower implications, then a more statutory approach may become more attractive among leading policy makers.