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

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

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".

cases CAC's will help, particular

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.