



United Nations

Special event of the Second Committee of the General Assembly

**Sovereign Debt Crises and Restructurings:
Lessons Learnt and Proposals for Debt Resolution Mechanisms**

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Concept note

Prepared by the UNCTAD secretariat

The international community is still far from a consensus on the costs and benefits of a structured mechanism for dealing with sovereign insolvencies. However, there is broad agreement that this important issue should be brought back to the centre of international debate. The need for such a discussion has been highlighted and recognized by General Assembly resolution 66/189, which decided to devote one of the special events during the sixty-seventh session of the General Assembly to discussing lessons learnt from debt crises, and to assessing the ongoing work on sovereign debt restructuring and debt resolution mechanisms so as to guide policy-makers in shaping the future global agenda.

A brief history

The debate on whether the international system needs a mechanism for dealing with sovereign defaults is by no means new, and dates back to the mid-1970s. From the very beginning, the United Nations system has played a leading role in the global discourse on sovereign debt restructuring. In 1977, the United Nations Conference on Trade and Development (UNCTAD) called for explicit principles for debt rescheduling in its document entitled “Selected Issues Relating to the Establishment of Common Norms in Future Debt Renegotiations” (TD/AC/2/9). In 1980, UNCTAD’s Trade and Development Board endorsed a set of “Detailed Features for Future Operations Relating to the Debt Problems of Interested Developing

Countries.” These detailed features recognized that “finding a means through which debt-servicing difficulty could be avoided was one of the most important tasks facing the international community.” It then added that “problems could arise, and it is important to have agreed arrangements for timely action,” and concluded that “in the multilateral forum agreed upon by the debtor and creditors, the Chairman would conduct the debt operation in a fair and impartial manner, in accordance with the agreed objectives, so as to lead to equitable results in the context of international economic cooperation.” In 1986, UNCTAD’s *Trade and Development Report* included a detailed proposal for establishing a procedure for sovereign debt restructuring, based on Chapter 11 of the United States Bankruptcy Reform Act of 1978. The *Trade and Development Report* also discussed the need for an insolvency procedure for sovereign debt in its 1998, 2001 and 2009 issues. The debate on the creation of an insolvency mechanism for sovereigns took centre stage again when IMF advanced a proposal to create a Sovereign Debt Restructuring Mechanism (SDRM) in the wake of the Argentinean default of 2002/2005. The SDRM project was abandoned when it became clear that the initiative lacked the necessarily political support for the creation of such a mechanism. As an alternative to the SDRM, countries began issuing bonds with Collective Action Clauses (CACs), postulating that a majority of bondholders could amend any of the terms and conditions of the bonds. With the onset of the global financial and economic crisis, calls to consider more structured approaches to resolving debt problems were underlined in General Assembly external debt resolutions 64/191, 65/144 and 66/189, and in the Doha Declaration (63/239) and the outcome of the United Nations Conference on the World Financial and Economic Crisis (63/303).

Problems with the status quo

Governments, like private debtors, can find themselves in a situation where they are unable to service their debts. However, while domestic laws contain well-defined procedures for enforcing private debt contracts and for dealing with private bankruptcies, in the case of sovereign debt, creditors have limited legal recourse, since there are very few rules on how creditors and debtors should behave in a context of sovereign bankruptcy. On the one hand, limited enforceability is only partly due to the principle of sovereign immunity, which protects sovereign States from lawsuits in foreign courts. Consolidated legal interpretations suggest that sovereign immunity may not apply to debt contracts and that sovereign borrowers can waive their immunity (as a consequence, sovereign States have been successfully sued in foreign courts), but rulings by foreign courts remain difficult to enforce because creditors can only attach assets located outside a country’s border. As sovereigns cannot be subjected to norms such as Chapter 7 (“liquidation”) of the United States bankruptcy code and as they usually do not have assets abroad, they enjoy wide discretion in paying their creditors, sometimes violating informal or customary rules.

This last point leads us to the second and more general aspect of the current scenario: there are no rules to effectively tackle collective action problems that usually come into play when insolvency is approaching, as is described in more detailed below.

Limited enforceability and the lack of basic rules in this realm do not prevent the creation of a mechanism for facilitating the restructuring of sovereign debt. However, the desirability of such a structured mechanism remains a contentious issue. Those who favour a reform in this direction suggest that the lack of such a structured mechanism is a major failure of the current international financial architecture, which leads to long delays in debt restructuring, unfair outcomes, and loss of value for both debtors and creditors. Those who oppose the creation of such a mechanism argue instead that the current system has all the necessary contractual instruments for dealing with sovereign defaults, and that the creation of new institutions or mechanisms for dealing with sovereign insolvencies would be useless at best and dangerous at worst.

The ideal starting point for a discussion on the desirability of a structured approach to sovereign debt restructuring is a careful analysis of the problems that such a mechanism should address. The recent experience and literature on sovereign debt and sovereign default has highlighted five problems with the current approach to sovereign debt restructuring.

(a) **Lengthy debt renegotiations which, in some cases, do not restore debt sustainability.**

A study of 90 defaults and renegotiations on debt owed to private creditors by 73 countries found that debt renegotiations have an average length of over 7 years, produce average creditor losses of 40 percent, and lead to limited debt relief. The same study found that the situation is particularly problematic for low-income countries.

(b) **Need to coordinate the interest of dispersed creditors and to deal with bondholders who have an incentive to hold out from debt restructuring deals.**

Even if creditors could be better off by writing off part of their claims, debt cancellation requires a coordination mechanism that forces all creditors to accept some nominal losses. In the absence of such a coordination mechanism, each individual creditor will prefer to hold out while other creditors cancel part of their claims. Coordination problems and the possibility of free riding are particularly serious in the case of bonded debt, and are exacerbated by the presence of vulture creditors who buy the debt at deep discount on the secondary market with the explicit intention of litigating after the majority of creditor have reached a settlement with the defaulting country.

(c) **Lack of access to private interim financing during the restructuring process.** In the corporate world, interim financing is guaranteed by the presence of debtor-in-possession (DIP) financing provisions, but sovereign debt lacks a mechanism able to enforce seniority. Lack of

access to private interim financing may amplify the crisis and further reduce the ability to pay, because during the restructuring period countries may need access to external funds to either support trade (trade credit) or to finance a primary current account deficit.

(d) **Overborrowing caused by debt dilution.** Debt dilution refers to a situation in which, when a country approaches financial distress, new debt issuances can hurt existing creditors. In the corporate world, debt dilution is not a problem, because courts can enforce seniority rules.

(e) **Delayed defaults.** While most economic models of sovereign debt assume that countries have an incentive to default too much or too early, there is evidence that countries often try to postpone the moment of reckoning and may sub-optimally delay the beginning of the debt restructuring process. A prolonged pre-default crisis may reduce both ability and willingness to pay, making both lenders and borrowers worse off.

Restarting the discussion

This special event aims at addressing the following five questions.

1. Do the issues listed above adequately reflect past experience with the current system for the dealing with sovereign defaults?
2. Are there other problems with the current system for dealing with sovereign defaults?
3. Can the problems listed above be addressed with a structured mechanism for the resolution of sovereign debt crises?
4. What would be the governance and organization of such a structured mechanism?
5. Would the costs of a structured mechanism dominate its potential benefits?