

MULTILATERAL DEBT RESTRUCTURING MECHANISM

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Ad hoc Committee on a multilateral legal framework for a sovereign debt restructuring
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1. Introduction

- Debt restructuring is an **efficient** mechanism of market economies.
- It has been recognized at the domestic level in bankruptcy procedures, both for private as well as official debtors.
- Basic principle: “fresh start”. This is good for debtors **and** creditors.
- It has been recognized internationally with official creditors, in the Paris Club, as well as sporadically in the Brady Plan and the HIPC Initiative and later in the Multilateral Debt Relief Initiative. But before in the debt relief given by the US to Latin American countries starting during the “Good Neighbor Policy” of FDR, and after the WWII for allies, notably to UK.
- The international mechanism should include both crisis prevention and crisis resolution mechanisms.
- This has been a periodic debate in recent times, unleashed by international crises: the Latin American debt crisis, the Mexican and Asian crises of the 1990s, the US courts decisions on Argentina, the Greek elections...

2. Crisis prevention

- **Procyclical behavior** of borrowers **and** creditors, leading to high debt ratios that provide little room to maneuver when a crisis strikes. Also, misuse or inefficient use of funds.
- Over-borrowing by private agents can also become an official problem as private debts are “nationalized” during crises, particularly through bailouts of financial institutions.
- Moral hazard problems, particularly in the latter case but also in the former case through rescue mechanisms (the European Stability mechanisms being a case in point).
- Major **unexpected shocks** or incapacity to foresee crises/over-optimism during booms.
- Even more importantly, **unstable debt dynamics when a crisis strikes**, that can lead to rapid increase in debt ratios. The crucial issue: relation between nominal interest rates and nominal GDP growth. This also determines the level of sustainable debt ratios, which are much higher if countries have access to low interest debts (with higher interest rates generating “debt intolerance”).
- There are major **information problems** that may lead to difficulties in identifying the problem, including “hiding” public sector debts through derivative operations, public sector insurance or contingency mechanisms in public-private partnerships and, of course, implicit bailout procedures for domestic financial institutions.
- In this regard, transparency should be an essential principle.

3. Basic institutional mechanisms

- Multilateral **surveillance** during periods of prosperity (an IMF task).
- **Contingency clauses** in debt contracts: GDP- and commodity-price linked bonds. IFIs should be “market makers” for these instruments. In the past, the “bisque clause” in the 1946 financial arrangement between the US and UK, which gave the UK a waiver on the 2% interest payments in any year in which UK foreign exchange income could not finance its pre-war import level.
- **Contingency financing**: automatic/unconditional mechanisms to manage liquidity crises and avoid rapid build-up of debts. Best cases: swap arrangements and SDR issues; some IMF credit lines (Flexible Credit Line, Precautionary Credit Line), even better the compensatory finance facility from the 1960s and oil credit lines of the 1970s.
- Mechanisms to manage solvency problems: **a debt workout mechanism— and avoid using it “too little, too late”**.

4. A debt workout mechanism

a. Contractual approach

- Any mechanism must involve negotiations between debtors and creditors under the conditions established in debt contracts.
- But there are **three major problems: the first is avoiding holdouts** and court rulings that effectively discriminate in favor of them (thus creating equity issues among creditors).
- Collective action clauses were a way forward
- So were the aggregation clauses, adopted first by the EU and last year by the ICMA and the IMF, and now being introduced in debt contracts. The same is true of the redrafting of the “pari passu” clause.
- But this system is clearly insufficient. This is associated to the second problem: it is particularly prone to the **problem of “too little, too late”**, which is related to the bias it creates in favor of creditors, associated with the desire of debtors to keep access to credit.
- This is why domestic negotiations take place under “the shadow of the court”.
- A third problem is the **lack of uniform rules**, which may lead to equity issues among debtors (associated with the negotiating capacity of countries) but also among creditors.

b. Basic principles:

- Basic principle under which it should operate: “a fresh start”, which means **debt sustainability** in the double sense that it allows countries to grow (and achieve development goals) and, at the same time, pay its restructured debts.
- **Protection of creditor rights**, but this should be understood in a broad sense, as a good debt resolution mechanism is consistent with creditor interests.
- Restructuring should be **comprehensive**.

- **Decisions are binding in all states and for all creditors**, as well as standstill provisions on debt disputes while negotiations take place.

c. Statutory approach:

- A mechanism similar to the WTO dispute settlement: voluntary negotiations, mediation and arbitration with clear deadlines.
- Its use would be initiated by request of the restructuring state (not forced by any multilateral institutions), and may or may not involve default (so, it could be used while servicing the debt, though the risks of capital flight are high; capital controls can be used all along).
- The first two take place under the principles established in debt contracts, but deadlines help accelerate agreement.
- The latter two should take place under agreed principles.
- This should include all private claims with clear priorities in favor of those agents that provide financing during crises (including trade financing, if the latter goes uninterrupted).
- This raises issues about whether multilateral and official lending should be introduced. Perhaps not lending by the IMF and IFIs but perhaps non-Paris Club official lending (which might include the European Stability Mechanism) and a principle that Paris Club restructuring would be at least in the same terms.
- Where should it be located? It could be a UN institution but also the IMF, if the mediators/arbitrators are clearly independent of the Board and the Administration.
- Alternative: case-by-case arbitration panels convened by the relevant parties under internationally-agreed arbitration rules. The proposal of Argentina of an “Oversight Commission” made up of three States belongs to this category. The problem: how to guarantee equal treatment under a case-by-case basis.
- Fear of a creditor-friendly system (as many indicate is a feature of current investment dispute settlement): should there be a “second instance”? My answer is no.
- Multilateral facilities to support return to markets... and possibly new lending obligations by creditors that participate in the process.
- A system for the verification of claims is essential.
- The immunity of sovereign assets should be respected all along.
- The system may also contain some automatic debt relief principles.

d. Complications:

- Derivate operations, which in some cases conflict of interests (and even fraud), particularly when creditors hold credit default swaps.
- Contingency contracts with private agents.

- Domestic debts that are held by foreign portfolio investors should be included, but other domestic debts should not.
- Other domestic liabilities of national governments, particularly with pensioners, should not be included.

e. **Complementary mechanisms:**

- A **proper sovereign debt registry**, including relevant contingency mechanisms, is essential for the proper functioning of the debt restructuring mechanism. It should be included in the mechanism being discussed at the UN.
- Given the complexities of debt conditions, **sovereign debt forum** should be part of the institutional set up, to facilitate dialogue between creditors and debtors.