



## BRAINSTORMING MEETING ON A DEBT WORKOUT MECHANISM

### MEETING SUMMARY

The informal brainstorming meeting organised by UNCTAD in Geneva on 1 February 2013, focused on the building blocs of a possible Debt Workout Mechanism (DWM) and options to design a DWM acceptable to relevant stakeholders. On this occasion, the experts concentrated on the three following aspects: The theoretical and empirical problems a debt workout mechanism should address, its essential elements and, concrete options for a DWM to be acceptable to stakeholders. The sources of resistance to various proposals for debt restructuring mechanism were also discussed.

#### I. MAIN CONCERNS BEHIND THE CALL FOR A DWM

##### 1- Procrastination

One major issue with the current system is procrastination, or the lack of political will to make a timely decision for restructuring unsustainable debt. This leads to further accumulation of debts, which is harmful for both the debtor country and the creditors. What was called "the gamble for redemption" finds its source in at least three causes. The first reason is linked with the fear of politicians to lose either their own positions or their party's election altogether. Secondly, it is difficult to distinguish insolvency from illiquidity. The third reason is the fear of contagion. It was concluded that the lack of clarity on the process of a debt restructuring was a critical factor contributing to the paralyzing fear of the decision makers in a sovereign debt crisis.

##### 2- Creditor coordination and holdout litigations

An important factor contributing to the official sector's reluctance to restructure sovereign debt is the prospect of having to deal with litigations.

##### 3- Forum fragmentation

The absence of a global forum dealing with the resolution of debt has led to decisions being made at the local level in a wide range of institutional contexts at the expense of global coherence. Participants were concerned about forum fragmentation, giving the impression that scattered tribunals are resolving small centralized preliminary issues when in fact, they are making important decisions.

#### II. BUILDING BLOCS OF A DWM

The meeting went on to discuss the essential elements that should compose a debt workout mechanism. The following elements were discussed with a view to dealing with the identified problems of procrastination, creditor un-coordination and forum fragmentation.

##### 1- A standstill/stay of litigation/moratorium (automatic or not)

Discussions about a standstill emerged as a technical solution to procrastination. Indeed most participants agreed on the fact that, although it may be the "toughest nut to crack", it would certainly take a significant part of terror out of the debt restructuring process by creating a moment of appeasement, deprived of hostile actions on the part of creditors, around the decision making process. The difficulty to establish such a rule in the context of a debt restructuring was



nonetheless made clear as this runs contrary to bond holder's right to go to courts and pursue legal remedies. On the practical level, the decision to enforce a standstill was discussed. While the question of sovereignty commands that the debtor country should be in charge of announcing the decision to enforce a standstill on its debt repayments, concerns were expressed as to the stigma that it may imply and the consequences for access to interim finance. The question of stigma was debated to the extent that such standstill could also be seen as reducing the stigma inflicted to the debtor country if the process was carried out in agreement with creditors.

Some views pointed to the possibilities of using indicators as proxy to make the decision to enforce a standstill.

### 2- Debts thresholds, DSA, over-borrowing

The participants discussed the possibility of the establishment of debt warnings and monitoring in the form of thresholds not only in regard to budget deficits but also to current account deficits and to the private sector debts. This would possibly imply monitoring agencies ensuring the transparency of information and allowing creditors to make relevant decisions. For some participants, these could be used as indicators helping the identified decision makers to justify the need for a restructuring. The difficulty to design debt sustainability thresholds was once again highlighted (re. Japan) in light of the complexity of economic situations and the poorness of indicators used to assess these situations (e.g. debt to GDP ratio or even human rights). Proponents of rules based on debt thresholds explained that it is not about forcing countries to default through an automatism but to tie their hands in what they can do when they go about this threshold.

### 3- Transparency

Transparency of information on countries' debt situations was deemed crucial to pre-empt debt crises. In theory, it would allow prospective lenders to make informed decisions about the capacity of a country to repay its debts. If lenders then decide to extend credit notwithstanding insurmountable existing debts, they should acknowledge a part of responsibility when a default is declared. If, on the contrary, they refuse to lend, they should be provoking a change in financial governance on the sovereign debtors' side. It was further explained that in the political world, transparency measures have to be accompanied by adequate supervisory agencies which would be in charge of dealing with inter-generational justice. Such agencies cannot exist at the domestic level as there would be a conflict of interest (politicians are mandated to represent the current population) and this is why it was argued that they should exist at the international level

### 4- Comprehensiveness and seniority

Participants highlighted the necessity to have a system that allows all types of creditors to be dealt with under a single procedure in the case of a debt restructuring. The relevance of the preferential status of the IMF was acknowledged. On the question of seniority in bond issues, it was suggested that it would be possible to include a sort of negative pledge contractual clause,<sup>1</sup> which would prevent issuers from giving preferential terms to lenders succeeding those who participated in a debt restructuring.

Participants wondered whether domestic debt should be included in the debt restructuring process. They were divided on this question since it seems difficult to interfere with domestic adjudication for sovereignty reasons. It was nevertheless argued that following the ultimate goal of a restructuring, domestic debt should be included in the process so as to avoid a relapse. A further

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<sup>1</sup> Not to incur secured indebtedness in favour of future creditors without equally and rateably securing your past debt. If you borrow under different terms, it triggers a default.



observation pointed out that the answer very much depends on the nature of the debt unsustainability and the ability of a country to make both or either external and/or internal transfers.

The third aspect of the discussion is in relation to fora of adjudication for sovereign debt. Participants argued against the multiplicity of these fora for reasons of coherence and coordination among creditors, who often use this state of play in order to hold out from a restructuring process (re. forum fragmentation above).

#### 5- Legitimacy

The inclusion and assessment of illegitimate debt within the framework of a DWM was subject to debate. Participants were divided on this question. Some suggested that whilst the concept of legitimacy in regards to debt is vague, it should still be subject to enquiry. It was objected that verification of claims does not lead to determining whether a debt is legitimate or not and that by linking the discussion about debt legitimacy to the debt restructuring process, this process would be made very uncertain for creditors. Others stated that the only way to manage illegitimate debts is to decide ex ante that lending to a certain regime is illegitimate and that the successors of this regime will not be bound to pay those debts.

#### 6- Impartiality

The goal of a DWM being to ensure a fair and efficient approach to debt restructuring at the international level, the impartiality of both its debt sustainability evaluation process and its decision making forum is crucial to achieve timely coordination between stakeholders. Some participants however contended that the impartiality of the decision making forum/body should be ensured by the appointment process of its adjudicators. Others argued that even if the appointment process is impartial, the political decision of distributing the costs of a restructuring is too heavy for two or three adjudicators.

### III. CONCRETE OPTIONS FOR A DWM

The brainstorming discussions fleshed out various design options for a DWM. Although not entirely new, these options carry suggestions that will be considered carefully in the context of UNCTAD's initiative for a DWM.

#### 1- A statutory approach

Several participants called for the establishment of ad hoc arbitration panels which would be making decisions on sovereign debt matters with the help of specialised institutions commissioned also on an ad hoc basis. A question as to the complementarity of an arbitration process and negotiating committees was raised. It was suggested that the areas of competence of the panel should be clearly defined so as to prevent their involvement with policy decisions (such as setting minimum standards on debt sustainability for instance). Indeed, the functions of a tribunal, which is to apply the law, should not be confused with that of policy making. Whilst some participants objected to the establishment of such an institution for reasons of costs and sovereignty, others envisaged a less formal authority with the powers of setting international standards for adjudicating on sovereign debt issues at the domestic and international levels and with limited authority to adjudicate in very specific cases. For the purpose of fighting against forum fragmentation, it was suggested that sovereign debt decisions should be made in institutional settings of similarly high hierarchical status if they are not centralized in a single body.



## 2- An informal approach

The participants questioned the value of having an institutional framework set in hard law when it could be set in soft law, especially if it was decided that legal decisions on debt restructurings should be made at the domestic level but made compliant with general standards centralised and monitored at the international level. Participants argued that the answer would depend on how these standards were to be articulated and how they were to be perceived by the creditors. If these standards were to be articulated by domestic tribunals and then funnelled into international law, it may create unpredictability because of the likely heterogeneity in decision making. If they are established upfront, creditors will be able to decide on the risks they want to run.

## 3- An institutionalized market approach

On the front of flexibility, participants argued that the easier way to enforce standards was through a contractual approach, which could ally (as in the recent case of Mongolia) recourse to an arbitration body with the most adequate country laws. Going further, the terms of the debt contract could stipulate that the relevant tribunal should consider fairness and justice in deciding on a restructuring.

Proponents of a market approach further argued that the contractual approach could be complemented by a statutory approach in specific contexts such as the Euro-zone or post-conflict areas in which the UN Security Council has a say.