

The Present State of the Discussion on Restructuring Sovereign Debts: Which Specific Sovereign Insolvency Procedure?

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Four proposals regarding the debt crisis are presently on the table: Collective Action Clauses (CACs), a voluntary Code of Good Conduct for debt re-negotiation proposed by the Banque de France, and two models of sovereign insolvency. The latter are the IMF's SDRM and my model emulating the basic principles of US municipal insolvency, called Chapter 9 in the US, which was taken up by NGOs, most notably the Jubilee movement. To avoid the word insolvency many NGOs prefer to call it Fair Transparent Arbitration Process (FTAP). Often it is alleged that the former two proposals contradict or preclude sovereign insolvency. This is fundamentally wrong. Helping creditors to organise, to be able to act more quickly and efficiently, CACs are a helpful component of any insolvency rather than a contradiction to it. The proper functioning of fair insolvency procedures depends on the full ability of parties to defend their legal and economic interests. Creditors must be able to act efficiently - whatever helps them to do so is welcome. The Code of Good Conduct demands fair representation of creditors, an expeditious and co-operative process, fair burden sharing, preserving the debtor's financial situation, reaching debt sustainability as soon as possible, also arbitration - briefly, many elements of Chapter 9 insolvency.

Whenever CACs or the Code should be able to prevent formal insolvency procedures this would be great. The very existence of an insolvency mechanism would be helpful in making these options more efficient. Sovereign insolvency is a solution of last resort, an emergency exit necessary and useful, but better avoided. Any sane interceptor pilot insists on having an ejector seat and on making sure it works perfectly. But no sane pilot uses it for ending routine flights, or if (s)he can land the plane. Like an emergency seat, insolvency is not an easy way out. It is a thorny choice, not least to the debtor.

By contrast, the two models of sovereign insolvency, the IMF's SDRM and my Chapter 9 based debt arbitration do contradict each other. This paper will list the similarities of these two models, the concerns about the SDRM, and the specific differences of an international Chapter 9.

Similarities of Chapter 9 and the SDRM

- Ø *Recognising the Necessity of Sovereign Insolvency*: Eventually recognising the need for an orderly framework to determine which part of their debts insolvent debtors can actually pay was quite a break away from the IMF's traditional debt management. So was Krueger's (2001, p.8) correct statement that this would reduce restructuring costs. There is full agreement between both alternatives (cf. Raffer 1989, 1990, 2002).
- Ø *Verification*: After denying the need and even the possibility of registering and assessing debts in the way usual in any domestic insolvency procedure, the IMF (2002, p.68) meanwhile demands specific checks regarding "for example, the authority of an official to borrow on behalf of the debtor", echoing what Raffer (1990, p.309) had demanded, nearly in my own words (Raffer 1993a, p.68).
- Ø *Stay-Standstill*: The idea that the debtor government's demand for an insolvency procedure should automatically preclude further lawsuits and legal enforcement by creditors during insolvency procedures (Raffer 1990) was taken up by the IMF. Nevertheless, the Fund's position remains unclear. In various documents the IMF has proposed quite different things ranging from an "implicit support to a temporary standstill" by the IMF (Krueger 2001, p.5) or the Fund's endorsing of a stay to variations allowing creditors to vote on it with or without the "hotchpot" rule. One may, however, say that stays are at least possible in both models - a similarity already including differences.
- Ø *(Private) Creditors Fully Subject to Arbitration*: Raffer (1989, 1990, 2002) has always been clear that all creditors should be subject to arbitration. The IMF exempts multilateral institutions from the SDRM, remaining evasive about Paris Club members that are also its main shareholders. Their claims may or may not be covered by the SDRM. All IMF documents, though, are clear that private creditors would be fully subject to arbitration - both a similarity and a difference to my model where private and public - including multilateral - creditors would be treated equally.

Concerns about the SDRM

Understandably, the SDRM immediately raised many justified concerns. First, it would have been no real change in debt management. The IMF would continue to take the important decisions as it

has done so far. Krueger (2002, p.4) puts it into a nutshell: "The Fund would only influence the process as it does now, through its normal lending decisions". Considering that the first adjustment measures were implemented in Sub-Saharan Africa some thirty years ago and the Fund's success there as well as in other debtor countries this is hardly encouraging.

There is concern about the strong institutional self-interest behind the SDRM, a strong increase of the Fund's importance. The IMF's Board determines sustainability - and thus automatically the amount of necessary debt reductions - as well as the debtor's economic policies. One variant gives the IMF the right to endorse the standstill. The whole SDRM procedure - down to absolutely minor details - is to become part of the Fund's Articles of Agreement. The "new judicial organ" (now called SDDRF), the selection criteria for its members, or even classification rules for the many creditor classes the IMF imagines would all become enshrined into the Fund's statute. The Fund proposed to help debtors to choose which debts to include into their SDRM-procedures. The SDDRF would be an IMF organ unable to challenge the Board's decisions. This "statutory approach" would firmly and officially install the IMF as the overlord of sovereign debt relief. Establishing the sole mandate for the Fund it would end the long turf war with the IBRD.

So-called "vulture funds" served as the argument why enshrining the SDRM into the Articles of Agreement should be necessary. Its rules should have the force of law universally. Rather than getting every country to amend its domestic bankruptcy law, amending the IMF's Articles was recommended in order to oblige all member states to change their domestic laws in a way that opposition of creditor minorities can be overruled. This argument in favour of the statutory approach is altogether flawed. Not all countries and territories are IMF members. The Cayman Islands, e.g., are not a member but enjoy enough autonomy to offer themselves as a place for creditors shopping for jurisdictions where unanimity is not required. They have routinely been used as an argument against the Tobin Tax vehemently opposed by the IMF. However, if this tax cannot be introduced because entities such as the Cayman Islands would preclude universal acceptance and thus implementation, the same argument holds logically for the SDRM.

The present *de facto* preferential creditor status of IFIs would be legalised. The Fund and multilateral institutions would remain exempt from financial accountability for their own decisions.

and aggravated crises increase their importance. An institutional self-interest in crises is built into the present system. While private creditors having to reduce claims feel the sting of the market mechanism, IFIs can increase their exposure, knowing that they will be protected. At present, n

. It would also fall behind the standards of the HIPC-Initiatives that broke the taboo of debt reductions by IFIs some years ago.

This attempt to save multilateral claims makes the IMF's assertion that the SDRM would be necessary to "bail-in" the private sector look very peculiar. As quite a few Miyazawa-Brady deals or the demand for parallel treatment by the Paris Club document, the private sector has already reduced claims - 35% off in Mexico or 45% in Ecuador cannot but be called generous. On the other hand, there is definitely a need for bailing-in the international public sector - not least for economic reasons - rather than for discriminating private creditors both financially and by such misleading formulations.

Specificities of Chapter 9 Based Debt Arbitration

The elements of my model that differ fundamentally from the SDRM are (for further details please go to <http://mailbox.univie.ac.at/~rafferk5>):

Respecting the Rule of Law

It is a sad feature of traditional debt management and the SDRM that some creditors take the important decisions. Public creditors have been judge, jury, experts, bailiff, occasionally even the debtor's lawyer all in one. This is unfair to debtors and other creditors. As the record shows, it has also been unsuccessful. By contrast international Chapter 9 procedures would be chaired by neutral *ad hoc* entities, by panels established by creditors and the debtor, as traditional practice in international law. Arbitrators would have to mediate between the parties, chair and support negotiations by advice, provide adequate possibilities to be heard for the affected population, and - if necessary - decide. In a domestic Chapter 9 case the affected population has a right to be heard. Internationally, this would have to be exercised by representation. Trade unions, entrepreneurial

associations, religious or non-religious NGOs, or international organisations such as UNICEF could represent the debtor country's population. Depending on the country, e.g., Christian organisations in Latin America or Muslim organisations in Muslim countries, should be organisations formally representing the population.

This really neutral entity - neither an organ of any creditor nor the debtor's - would also give a greater say to the parties, creditors (except the IMF) and the debtor, than the SDRM. Neutral arbitration must, of course, be applied to all insolvent debtors, also to present HIPC's whose debt reductions are still decided by public creditors violating the very fundament of the Rule of Law.

Treating the Problem of Sovereignty

Chapter 9 is the only procedure protecting governmental powers, and thus applicable to sovereigns.

The concept of sovereignty does not contain anything more than what §904 protects in the case of US municipalities. The court's jurisdiction depends on the municipality's volition, beyond which it cannot be extended, similar to the jurisdiction of international arbitrators. Unlike in other bankruptcy procedures liquidation of the debtor or receivership are not possible. Change of "management" of US municipalities (i.e. removing elected officials) by courts or creditors is not possible - nor should it be in the case of sovereigns. On the other hand, any insolvent debtor is economically under pressure to solve the debt problem and to regain normal access to capital markets. This forces debtors to offer realistic terms to creditors. US courts only confirm plans that are also in the best interest of creditors. So would the arbitration panel in my model.

Fairness

The SDRM is unfair to nearly anyone but the IMF. By contrast three elements of my model make it a fair procedure:

1) *Inter-Creditor Equity*: All debts, including multilateral claims, must be treated equally.

Multilateral development banks should finally obey their own statutes. Other creditors would no longer have to pay for the consequences of wrong or negligent decisions by multilateral institutions.

2) *Debtor Protection*: insolvency solves a conflict between two fundamental legal principles: the

right of creditors to stipulated payments and the human right recognised by all civilised legal systems that one must not be forced to fulfil contracts (regarding loans or others) if that causes inhumane distress, endangers life or health, or violates human dignity. Although claims are recognised as legitimate, insolvency exempts resources from being seized by *bona fide* creditors. Debtors - unless they are Developing Countries - cannot be forced to starve their children to pay more. Human rights and human dignity enjoy unconditional priority, even though insolvency only deals with claims based on solid and proper legal foundations. *A fortiori* this is valid for less well founded claims. Like with US municipalities, resources necessary to finance minimum standards of basic health, primary education or a fresh economic start must be exempt. Civil society meanwhile participates officially in designing poverty reduction strategies in HIPC's. The principle of participation by affected people is part of present debt management, no longer something totally new. In Argentina, e.g., civil society "participated" in the streets by banging pots. Formal representation is a better way than that.

None of the IMF's SDRM-documents so far contains the smallest hint of debtor protection, falling behind the standards HIPC II already established. Private creditors accept that there are politically uncollectable debts, which describes the principle of exempt resources in other words. Unlike the Fund they have repeatedly granted substantial debt reductions. Speaking of "bailing-in" the private sector is misleading and absurd.

A transparently managed fund financed by the debtor in domestic currency and monitored by an international board or advisory council would use exempt resources. Legally an entity of its own, checks and discussions would not concern the government's budget.

3) *Best Interest of Creditors*: as in the US the outcome of any internationalised insolvency procedure must also be in the best interest of creditors. The important point of fairness apart, no biased mechanism would be generally accepted, and rightly so. For a sovereign wishing to have new access to credit markets the way the debt overhang was dealt with is critical. If creditors feel that they have been treated fairly, they are likely to be as willing to provide new loans for economically promising projects in the future as creditors usually are after corporate insolvencies.

Sustainability

It emerges from transparent negotiations. Having all facts on the table, would practically restrict the panel's decisions to breaking deadlocks affecting minor sums. Unlike sustainability estimates

of the IMF in the past (usually based on overoptimistic projections), the result - based on all relevant arguments - would be stabler.

Speed

Chapter 9 based debt arbitration adapts functioning national and international procedures, it could be implemented immediately if and when important creditors, e.g., the G7 agree. Without or against them neither the SDRM nor Chapter 9 could be implemented. No new institution would be created. Panels would dissolve once they would have served their purpose. They could be asked to reconvene if disagreements should emerge later on. As insolvency procedures should and hopefully will remain exceptional in the future a standing institution would soon be severely underemployed.

Stabilising the Financial Architecture

The mere existence of sovereign insolvency would stabilise financial markets because the wrong assumption that countries will eventually always repay, on which the lending spree of the 1970s was based, would no longer be upheld. But the introduction of an international Chapter 9 should also be used as an opportunity for stabilising regulatory changes. Regulatory norms unnecessarily harassing creditors (creating so-called legal risk) should be changed. Most important globalising the tax-deductibility of loan loss reserves as presently practised on the West-European continent would be a cheap and efficient built-in stabiliser for the financial architecture. The problems money centre banks faced in the early 1980s could be avoided.

Concluding Remarks

The rejection of the SDRM during the 2003 Spring Meeting by the U.S. and some emerging markets precluded the introduction of an unfair, self-serving, and inefficient system. But the search for a viable solution is not over. The IMF will go on propagating its model, and the discussion will erupt with the next big crisis if not earlier. Therefore, both creditors and debtors, especially those opposing the SDRM, should study alternatives.

There is a strong and convincing case for one specific type of insolvency appropriate for sovereign debtors, an arbitration process based on the principles of US Chapter 9. Unlike the SDRM it could be implemented quickly and it would be fair to all concerned, avoiding the unnecessary costs on debtors and the international community, which Krueger rightly decried.

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