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SOVEREIGN DEBT RESTRUCTURING—RECENT DEVELOPMENTS AND IMPLICATIONS FOR THE FUND'S LEGAL AND POLICY FRAMEWORK

EXECUTIVE SUMMARY

There have been important developments in sovereign debt restructuring since the last Executive Board discussion of the subject in 2005. Since the last Board review, Greece launched the largest sovereign debt restructuring in history in February 2012. Other recent restructurings include Belize (2007, 2013), Jamaica (2010, 2013), St. Kitts and Nevis (2012), and Grenada which has announced the intention to restructure its public debt. Separately, ongoing litigation against Argentina could have pervasive implications for future sovereign debt restructurings by increasing leverage of holdout creditors. There has also been active discussion of debt restructuring issues in international fora and the Institute for International Finance has recently issued an annex to its Principles in light of the restructuring experience in Greece.

Against this backdrop, this paper reviews the recent application of the Fund's policies and practices on sovereign debt restructuring. Specifically, the paper:

- recaps in a holistic manner the various policies and practices that underpin the Fund's legal and policy framework for sovereign debt restructuring, including on debt sustainability, market access, financing assurances, arrears, private sector involvement (PSI), official sector involvement (OSI), and the use of legal instruments;

- reviews how this framework has been applied in the context of Fund-supported programs and highlights the issues that have emerged in light of recent experience with debt restructuring; and

- describes recent initiatives in various fora aimed at promoting orderly sovereign debt restructuring, highlighting differences with the Fund's existing framework.

Based on this stocktaking, the paper identifies issues that could be considered in further depth in follow-up work by staff to assess whether the Fund's framework for debt restructuring should be adapted:

- first, debt restructurings have often been too little and too late, thus failing to re-establish debt sustainability and market access in a durable way. Overcoming these

problems likely requires action on several fronts, including (i) increased rigor and transparency of debt sustainability and market access assessments, (ii) exploring ways to prevent the use of Fund resources to simply bail out private creditors, and (iii) measures to alleviate the costs associated with restructurings;

- second, while creditor participation has been adequate in recent restructurings, the current contractual, market-based approach to debt restructuring is becoming less potent in overcoming collective action problems, especially in pre-default cases. In response, consideration could be given to making the contractual framework more effective, including through the introduction of more robust aggregation clauses into international sovereign bonds bearing in mind the inter-creditor equity issues that such an approach may raise. The Fund may also consider ways to condition use of its financing more tightly to the resolution of collective action problems;

- third, the growing role and changing composition of official lending call for a clearer framework for official sector involvement, especially with regard to non-Paris Club creditors, for which the modality for securing program financing commitments could be tightened; and

- fourth, although the collaborative, good-faith approach to resolving external private arrears embedded in the lending into arrears (LIA) policy remains the most promising way to regain market access post-default, a review of the effectiveness of the LIA policy is in order in light of recent experience and the increased complexity of the creditor base. Consideration could also be given to extending the LIA policy to official arrears.

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CONTENTS

BOXES

FIGURE

TABLES

ABBREVIATIONS AND ACRONYMS

CACs	Collective Action Clauses
CDS	Credit Default Swaps
DSA	Debt Sustainability Analysis
ECCU	Eastern Caribbean Currency Union
ECF	Extended Credit Facility
ECRM	European Crisis Resolution Mechanism
EFF	Extended Fund Facility
EPCA	Emergency Post Conflict Assistance
ESM	European Stability Mechanism
FRAN	Fixed Rate Accreting Notes
FTAP	Fair and Transparent Arbitration Process
GCAB	Global Committee of Argentina Bondholders
GDP	Gross Domestic Product
GGB	Greek Government Bonds
HIPC	Heavily Indebted Poor Countries
IDRC	International Debt Restructuring Court
IIF	Institute of International Finance
ISDA	International Swaps and Derivatives Association
LEG	Legal Department
LIA	Lending into Arrears
MCM	Monetary and Capital Markets Department
NPV	Net Present Value
OSI	Official Sector Involvement
"Principles"	Principles for Stable Capital Flows and Fair Debt Restructuring
PSI	Private Sector Involvement
SBA	Stand-By Arrangement
SDF	Sovereign Debt Forum
SDRM	Sovereign Debt Restructuring Mechanism
SDT	Sovereign Debt Tribunal
SPR	Strategy, Policy, and Review Department
UN	United Nations
WAEMU	West African Economic and Monetary Union

I. INTRODUCTION

1. The Executive Board last reviewed the experience with sovereign debt restructuring in 2005. In the report for that Board discussion staff provided an update of developments in a number of sovereign debt restructuring cases, described progress in the inclusion of collective action clauses (CACs) in sovereign bond issuances, reviewed the *Principles for Stable Capital Flows and Fair Debt Restructuring* ("Principles") by the Institute of International Finance (IIF), discussed Paris Club related issues, including progress under the Club's Evian Approach, and examined the determinants and prospects for regaining market access by countries emerging from debt crises.[1]

2. There have been important developments in sovereign debt restructuring since the last Board review. In February 2012, Greece launched the largest sovereign debt restructuring in history covering EUR 205 billion in debt. Other sovereign debt restructurings have also recently taken place, including Belize (2007, 2013), Jamaica (2010, 2013), and St. Kitts and Nevis (2012), and Grenada has announced the intention to restructure its public debt. Separately, ongoing litigation against Argentina could have wide implications for future sovereign debt restructurings. There has also been active discussion of debt restructuring issues in international fora and the IIF has recently issued an annex to its *Principles* in light of the restructuring experience in Greece.

3. Against this backdrop, and given the current outlook for debt, this paper reviews the recent application of the Fund's policies and practices on sovereign debt restructuring. It begins by recapping in a holistic manner the various policies and practices that underpin the Fund's legal and policy framework for sovereign debt restructuring, including on debt sustainability, financing assurances, market access, arrears, private sector involvement (PSI), official sector involvement (OSI), and the use of legal instruments (Section II). The paper next reviews how this framework has been applied in practice and highlights issues that have emerged in light of recent experience with debt restructuring (Section III).[2] The paper does not provide reform proposals, but notes areas where further work would be needed to inform any change to the existing framework. Section IV describes recent initiatives aimed at promoting orderly sovereign debt restructuring, highlighting differences with the Fund's existing framework for debt restructuring. Section V summarizes issues for Directors' consideration.

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[1] See *Progress Report on Crisis Resolution*, which was the last of a series of such reports prepared regularly to brief the Board on developments with respect to resolving debt crises. In 2006 staff prepared an analytical paper for the Board's information—*Cross-Country Experience with Restructuring of Sovereign Debt and Restoring Debt Sustainability*, —that examined the initial conditions that gave rise to debt restructurings, discussed the impact of such restructurings in each of these cases, and provided an assessment of whether sustainability had been restored.

[2] The restructurings covered include Argentina (2005, 2010), Dominican Republic (2005), Grenada (2005), Ecuador (2009), Belize (2007, 2013), Seychelles (2009), Jamaica (2010, 2013), Greece (2012), and St. Kitts and Nevis (2012). The review of country cases builds on *A Survey of Experiences with Emerging Market Sovereign Debt Restructurings*, and *The Eastern Caribbean Economic and Currency Union—Macroeconomics and Financial Systems* (2013).

4. This paper concludes that recent developments call for revisiting certain aspects of the Fund's sovereign debt restructuring framework. In particular, the paper identifies four issues that may merit further in-depth follow-up staff analysis: (i) debt restructurings have often been too little and too late, thus failing to re-establish debt sustainability and market access in a durable way; (ii) while creditor participation has been adequate in recent restructurings, the current contractual, market-based approach to debt restructuring is becoming less potent in overcoming collective action problems, especially in pre-default cases; (iii) the growing role and changing composition of official lending call for a clearer framework for official sector involvement; and (iv) although the collaborative, good-faith approach to resolving external private arrears embedded in the lending into arrears (LIA) policy remains the most promising way to regain market access post-default, a review of the effectiveness of the LIA policy is in order in light of recent experience and the increased complexity of the creditor base.

II. THE FUND'S LEGAL AND POLICY FRAMEWORK FOR SOVEREIGN DEBT RESTRUCTURING

A. Overview of the Framework

5. The Fund approach to debt restructuring is best understood in the context of the Fund's lending mandate. The Fund is mandated to provide financing to assist members in resolving their balance of payments problems within a timeframe that allows them to return to medium term viability and repay the Fund. In most Fund-supported programs, a combination of policy adjustment and financing from the Fund catalyzes spontaneous external financing from the private sector and, in some cases, new financing from the official sector. As a consequence, the member is able to continue to service its debt in accordance with its original terms and preserve market access.

6. The catalytic role of Fund financing is put to the test in cases where members with significant external indebtedness have lost—or are losing—market access. In these circumstances, the needs of the member are normally of such a magnitude that they exceed both the amount of financing that can be provided by the Fund and the adjustment capacity of the member.[3] Also, to ensure timely repayments to the Fund and medium-term external viability of the member, the Fund requires that there be adequate financing assurances from other sources to fill the residual gap, both during the period of the program and in the post-program period. Good prospects of regaining market access and debt sustainability are germane to the observance of the financing assurances policy. In the event that the financing gap cannot be filled with fresh resources (from the official and/or private sector), the Fund's policy on financing assurances explicitly

[3] Note also that Article VI, Section I of the Fund's Articles of Agreement stipulates that a member may not use Fund's resources to meet large and sustained outflows of capital.

encourages "the restructuring of creditors' claims on the country on terms compatible with balance of payments viability."

7. In cases where a member faces liquidity or solvency problems, debt restructuring may be required in order for the Fund to provide financial support. If the problem is one of illiquidity—when a country's liquid assets and available financing are insufficient to meet or rollover its maturing obligations—but there are good prospects that market access will be restored, the debt restructuring would typically involve the rescheduling of maturing obligations. If there are solvency concerns—where the country is no longer able to meet the present value of its debt obligations without indefinitely accumulating debt—the debt restructuring may need to involve a reduction in the debt stock.[4] In either case, the extent of feasible economic adjustment combined with available new borrowing (including financing from the Fund) is not sufficient to address the member's underlying balance of payments problem. Indeed, new financing—insofar as it adds to the member's debt burden—may actually exacerbate the member's solvency position. In all cases, the Fund is precluded from providing financing unless steps are taken to address the member's debt problems in a manner that restores sustainability, including via the restructuring of claims of the private and/or official sectors, and that will lead to renewed market access.

8. Once it is determined that achieving sustainability requires debt restructuring in addition to adjustment, there are broad benefits from pursuing a rapid debt restructuring. From the debtor's perspective, a delay—and the increase in indebtedness that can occur during the period of delay—will usually exacerbate the economic dislocation when the debt is eventually restructured.[5] A delay will also prolong a period of financial instability and subdued growth owing to debt overhang effects. From the perspective of the official sector financiers, the delay will accentuate problems of moral hazard and burden sharing, particularly if, during this period, the claims of private creditors are replaced by those of the official sector. Delays also make the eventual restructuring more painful for the residual private creditors who have not yet been bailed out.

9. In light of the above considerations, the Fund has established policies that provide guidance on two central questions.

- ***First, at what point does a member's debt become "unsustainable"?*** The Fund has developed policies (described further below) to address the question of whether the member's debt is unsustainable. The Fund's determination on this question has an important bearing on the timing of any restructuring. Although a decision to restructure sovereign debt is taken by the member, the member may feel that it has no choice but to do so if the Fund has decided that it can no longer provide additional financing in the absence of measures that will restore sustainability.

[4] As noted in *Assessing Sustainability*, sustainability incorporates the concepts of solvency and liquidity, without making a sharp distinction between them.

[5] Debtors are likely to weigh the benefits and costs of delaying a restructuring. Sturzenegger and Zettelmeyer (2006) analyze the debtor's incentives by comparing the costs of delay with the expected gain from avoiding a default altogether.

- ***Second, once a determination is made that the member's debt is unsustainable and that a restructuring is necessary, when and how should such a restructuring take place?*** The Fund's involvement is also central to this set of issues, in light of the fact that creditors who are engaged in the restructuring will look to the Fund for judgments as to how much debt relief is needed to achieve sustainability. These judgments will be formed in the context of the design of a program that will support the restructuring process. Moreover, the Fund will seek assurances that the restructuring will command sufficient creditor support and, more generally, that its terms will restore debt sustainability and ensure medium-term external viability. Accordingly, and as discussed below, while the Fund seeks to avoid micromanaging the debt restructuring process, it does have an interest in the timing and modality of the restructuring.

B. Debt Sustainability and Market Access

10. Debt sustainability is a key requirement for Fund lending. It is a prerequisite for external viability and therefore for the success of the program and for providing safeguards that the Fund will be repaid. Not surprisingly, the question of whether a member's debt is sustainable is most relevant when a significant amount of Fund financing is sought. For these reasons, the criterion on debt sustainability set forth in the exceptional access policy (that is, when the Fund lends above the normal access limits) is of particular relevance to this determination.

11. Closely related to the concept of debt sustainability is that of market access. The Fund's exceptional access policy also requires that the member has prospects of (re)gaining access to private capital markets within the timeframe when Fund resources are outstanding. The assumption underpinning this criterion is that, in order for a country to address its underlying problems and achieve medium-term external viability, it will need to restore investor confidence and establish capacity to regain access to international private capital. More generally, while a temporary loss of market access may not necessarily imply that debt is unsustainable, a protracted loss of market access would create the presumption that debt may not be sustainable. In practice, whether a country is assessed to have market access will depend on its ability to tap international capital on a sustained basis through the contracting of loans and/or issuance of securities across a range of maturities, regardless of the currency denomination of the instruments, and at reasonable interest rates. Moreover, as a means of safeguarding the Fund's resources, it will be necessary that the country does so at a pace that enables it to repay the Fund, taking into account the maturity structure of Fund financing. When Fund-supported programs embed debt restructuring, this requirement has an impact on the Fund's view as to how the debt restructuring should take place, as discussed in the following section.

12. Until May 2010, the exceptional access policy required that "a rigorous and systematic analysis indicates that there is a high probability that the member's debt is sustainable in the medium term." The formulation of this criterion reflected two competing considerations. On the one hand, it was recognized that the determination of sustainability was judgmental and that applying judgment was preferable to automatic "hard access limits" that would preclude flexibility in providing large-scale financing in circumstances where a member with significant debt can still manage its problems without a restructuring. On the other hand, there was concern that, because the issues *were* judgmental, there would be great pressure on the Fund to exercise this judgment in a manner that would enable it to continue to provide large financing in the absence of a restructuring. To balance these considerations, the exceptional access criterion introduced a form of "constrained discretion"; i.e., the policy required that the sustainability judgment would need to be made with "high probability." Importantly, and as discussed in the next section, in May 2010, in the context of the European crisis, the criterion was amended to create an exception to the requirement of "high probability" in circumstances where "there is a high risk of international systemic spillovers."[6]

13. The exceptional access policy notes that debt sustainability needs to be evaluated in a forward-looking manner, taking into account the intended restructuring of debt. Therefore, in the event that the Fund determines that a member's debt is unsustainable and the member decides to initiate the debt restructuring process, the Fund must make a judgment that the envisaged restructuring (i) makes the debt sustainable and (ii) is likely to be successful in the sense of attracting sufficient creditor participation and avoiding disruptive legal challenges. This latter issue is discussed in greater detail in the following section.

14. Because of the important role that the Fund's determination of debt sustainability plays in lending and restructuring decisions, considerable effort has been made over the years to develop a framework for rigorous debt sustainability analysis (DSA). Rigorous DSAs are also a key tool in crisis prevention efforts. A DSA provides a thorough examination of the structure of debt and projections for debt burden indicators in baseline, alternative, and stress test scenarios over the medium term (generally understood to cover a period of five years). In particular, debt sustainability requires a judgment that the primary balance needed to stabilize debt under both the baseline and realistic shock scenarios is credible, i.e., economically and politically feasible, and the level of debt is consistent with an acceptably low rollover risk and with preserving potential growth at a satisfactory level.[7] In the context of a Fund-supported program that involves debt restructuring, the DSA also plays the essential role of determining the envelope of financial resources that is available for debt service payments to official and private creditors by charting out the program's medium-term paths for key macroeconomic, policy, and financing variables.

C. Debt Restructuring Process

15. When a member decides to proceed with a debt restructuring, the Fund encourages the member to engage with its creditors in a collaborative process. In particular, the Fund always recommends that the member avoid default by remaining current on all debt obligations to

[6] Decision No. 14064-(08/18), adopted February 22, 2008, as amended.

[7] See *Assessing Sustainability*; *Sustainability Assessments—Review of Application and Methodological Refinements*,; *Information Note on Modifications to the Fund's Debt Sustainability Assessment Framework for Market-Access Countries*,; *Modernizing the Framework for Fiscal Policy and Public Debt Sustainability Analysis*,; and *Staff Guidance Note for Public Debt Sustainability Analysis in Market-Access Countries*.

the extent possible. Thus, a member should seek to initiate a "preemptive" debt restructuring and continue to service the original claims during the debt restructuring process. Assuming that a country in debt difficulties is likely to call upon financial support from the Fund, avoiding a default is important not only because it may exacerbate the immediate economic and financial dislocation, but also because it may undermine the member's capacity to reaccess international private capital in the medium term, which, as noted above, is a key requirement for Fund lending. Because speed is of the essence in preemptive cases, and recognizing that the member has to take decisions when default may be imminent, the Fund does not require a particular form of dialogue between creditors and the debtor and acknowledges that a non-negotiated offer, albeit following informal consultations with creditors, may be the most efficient way to proceed. Inter-creditor equity issues are more acute in pre-default restructurings given differences in the market value of debt of different maturities (after default, debt of different maturities is accelerated and due and payable immediately), and can only be resolved through a dialogue between the debtor and its creditors aimed at agreeing on how to treat different creditor claims in an equitable manner.

16. Recognizing that there will be cases where a default is inevitable, Fund policy enables it to provide support to members seeking to restore sustainability via a post-default debt restructuring. The Fund has adapted its lending policies over time to balance the need to promote orderly financial relations with the need to limit the scale of economic dislocations of members facing payment difficulties. In particular, the Fund has over time relaxed its policy on arrears to external private creditors to avoid situations where such creditors may exercise a veto over Fund lending decisions. The Lending into Arrears (LIA) policy seeks to support effective adjustment while facilitating orderly debt restructuring to restore external viability. It applies to (i) sovereign arrears to external private creditors and (ii) nonsovereign arrears to external private creditors stemming from the imposition of exchange controls. Under the policy, the Fund may lend to a member in sovereign arrears to external private creditors only where a judgment has been made that: (i) prompt Fund support is considered essential for the successful implementation of the member's adjustment program, and (ii) the member is pursuing appropriate policies and is making a "good faith effort" to reach a collaborative agreement with its private creditors (the policy sets expectations on the form of the dialogue between the debtor and its creditors consistent with the good-faith effort).[8] Among other things, this criterion is designed to ensure that efforts are being made to restore the member's relations with creditors, thereby increasing the likelihood that it will be able to regain access to capital markets. The LIA policy also provides that, in cases where an organized negotiating framework is justified by the complexity of the case and the creditors have formed a *representative* creditors committee, the sovereign would be expected to enter into good faith *negotiations* with this committee—which is a higher bar than the standard requirement for interactions with creditors prior to default. Nonetheless, the policy also establishes that it would be inappropriate for private creditors to be given a veto over the design of the financing plan or the adjustment program. Thus,

[8] See *Summing Up by the Acting Chairman on Fund Policy on Arrears to Private Creditors—Further Consideration*; and *Fund Policy on Lending into Arrears to Private Creditors—Further Consideration on the Good Faith Criterion*.

application of the policy allows flexibility to address the diversity of individual country circumstances.

17. In contrast, the Fund does not tolerate the existence of "unresolved" arrears to official bilateral or multilateral creditors. The Fund has developed a number of conventions how this policy of nontoleration is applied in practice. First, arrears to multilateral creditors are considered resolved if the program provides for their clearance.[9] Second, arrears to Paris Club official bilateral creditors covered by the anticipated terms of the Club's "Agreed Minute" are deemed resolved for Fund program purposes when financing assurances are received from the Paris Club prior to the approval of a request for use of Fund resources or completion of a review.[10] Finally, relying on the Paris Club's comparability of treatment principle, the Fund deems that non-Paris Club official bilateral creditors will restructure the member's debt on similar terms as the Paris Club creditors. In cases where there is no formal Paris Club Agreed Minute, tacit approval of an official bilateral creditor has been deemed sufficient to satisfy the Fund's arrears policy.[11] Such tacit approval is generally conveyed through non-objection in the Executive Board when the member's request for Fund financial support is discussed, notwithstanding the arrears.

18. The Fund has long recognized that collective action problems can impede the debt restructuring process. While private creditors as a group may recognize that support for a rapid restructuring is in their own interest, they may hesitate to agree to a restructuring out of concern that other creditors may hold out and press for full payment on the original terms after the agreement has been reached. Thus, collective action problems could either make restructuring unsuccessful due to the holdout strategy or cause delay due to uncertainty about creditor participation. Collective action problems are more acute in preemptive restructurings (i.e., prior to a default) when creditors recognize that if the debt restructuring is successful in the sense of attracting sufficient participation, the debtor will be inclined to pay holdouts and avoid legal challenges. Indeed holdouts have typically been paid in full after a preemptive restructuring.

19. During the early 2000s, the Fund discussed ways in which these collective action problems could be resolved while balancing the need to promote orderly financial relations. In the course of this debate, the concept of a statutory framework, the "Sovereign Debt

[9] The debtor authorities must have a credible plan and projected financing to eliminate arrears, but concurrence of the creditor on this plan is not required. With respect to arrears to the World Bank, upfront clearance of the arrears at the beginning of the Fund-supported program or an agreed plan between the member and the World Bank on terms of clearance over a defined period has generally been required in line with the terms of the 1989 *IMF-World Bank Concordat*.

[10] To the extent that arrears are not rescheduled by the deadline set forth in the Agreed Minute, the arrears are considered to arise anew for Fund program purposes, unless the Fund considers that the member has exercised its best efforts to conclude the rescheduling agreement.

[11] This approach has been used most commonly in the context of emergency assistance, where the expectation has been that such assistance would advance normalization of relations with official bilateral creditors and hence pave the way for regular treatment in a Fund arrangement. It has also been used in the context of Fund arrangements in a few cases, in the absence of a relevant Paris Club Agreed Minute, where there are either no Paris Club creditors involved or the Paris Club share in the arrears is too small.

Restructuring Mechanism" (SDRM), received considerable support within the Board, but failed to command the majority needed to amend the Fund's Articles of Agreement due to the members' reluctance to surrender the degree of sovereignty required to establish such a framework. Instead, the Fund signaled its support for an alternative, contractual-based, approach; i.e. the inclusion of collective action clauses (CACs) in international sovereign debt contracts[12] through multilateral and bilateral surveillance.[13] See Box 1 for a comparative analysis of the key features of SDRM and CACs.

[12] For purposes of Fund policy, international sovereign bonds comprise bonds issued or guaranteed by the government or the central bank, and which are either (i) governed by a law other than the law of the sovereign issues, or (ii) subject to the jurisdiction of a court outside the territory of the issuer.

[13] See *Summing Up by the Acting Chair on the Design and Effectiveness of Collective Action Clauses, and Encouraging Greater Use of Collective Action Clauses in Sovereign Bond Contracts*; and Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund of September 21, 2003.

Box 1. Key Features of Collective Action Clauses and the Sovereign Debt Restructuring Mechanism

Addressing Collective Action Problems. Collective action clauses (CACs)[1] and the Sovereign Debt Restructuring Mechanism (SDRM)[2] are both designed to address collective action problems and facilitate orderly debt restructuring by relying on a qualified majority voting by creditors. The majority voting feature helps shift decision making on a debt restructuring to creditors as a group to reflect their collective will, rather than from creditors to the debtor. The key difference, however, between CACs and the SDRM is that voting under CACs is achieved on a series by series basis while the SDRM contemplated aggregated voting across all debt instruments covered in a restructuring. Specifically:

- **Restructuring Agreement.** CACs enable a qualified majority of bondholders (typically 75 percent of the outstanding principal) to bind all bondholders within the same issue to the financial terms of a restructuring, either before or after a default. The SDRM required a restructuring agreement to be supported by 75 percent of the outstanding principal of verified claims on an aggregated basis, thereby binding all affected creditors.
- **Limitation of Creditor Enforcement.** Under CACs, normally 25 percent of the outstanding principal of a particular series is required to accelerate claims of such series after a default, and a simple or qualified majority can reverse such acceleration after the default has been cured. An even more effective provision can be found in trust deeds governed by English law, where the right to initiate legal proceedings on behalf of all bondholders is conferred upon the trustee, who is required to act only if, among other things, it is requested to do so by the requisite percentage of bondholders. Moreover, the terms of the trust deed ensure that the proceeds of any litigation are distributed ratably by the trustee among all bondholders. Under the SDRM, upon request of the activating member, and the approval of 75 percent of the aggregated outstanding principal of verified claims, a temporary suspension would become effective for all legal actions brought by creditors.

Key Features of SDRM. The SDRM would have established a statutory framework which would include the following additional key features:

- **Activation and scope of claims.** The SDRM would be activated only at the request of a Fund member who must represent that the debt to be restructured is unsustainable. It could apply to all external claims, not just international sovereign bonds.
- **Creditor Committees.** To encourage active and early creditor participation, a representative creditors' committee, if formed, would be given a role under the SDRM to address both debtor-creditor and inter-creditor issues. The debtor would bear the costs associated with the committee.
- **Priority Financing.** As a means of inducing new financing, a specified financing transaction could be excluded from the restructuring if the extension of such financing is approved by 75 percent of the outstanding principal of verified claims.
- **Termination.** The SDRM would terminate (i) automatically upon the certification of all restructuring agreements, (ii) by notice of the activating member, or (iii) upon completion of the registration and verification process if 40 percent of verified claims wish to terminate.
- **Independent dispute resolution forum.** The forum would be established to, inter alia, verify claims, adopt rules regarding the voting process, certify restructuring agreements, suspend legal proceedings, and adjudicate disputes. The Fund's Managing Director would designate a selection panel of judges or private practitioners who would in turn identify the pool of judges who could be called into service on the forum when the SDRM is activated.

1/ *Collective Action Clauses, Recent Developments and Issues*,); and *The Acting Chair's Summing Up on Collective Action Clauses—Recent Developments and Issues*.
2/ *Proposed Features of a Sovereign Debt Restructuring Mechanism*.

III. PRELIMINARY REVIEW OF POLICIES IN LIGHT OF RECENT DEBT RESTRUCTURING CASES

20. This section provides a preliminary review of Fund policies discussed in Section II in light of recent experience in sovereign debt restructuring. It identifies four issues that could be studied in further depth in follow-up staff work to assess if and how the Fund's sovereign debt restructuring framework should be adapted:

- debt restructurings have often been too little and too late, thus failing to re-establish debt sustainability and market access in a durable way;
- while creditor participation has been adequate in recent restructurings, the current contractual, market-based approach to debt restructuring is becoming less potent in overcoming collective action problems, especially in pre-default cases;
- the growing role and changing composition of official lending call for a clearer framework for official sector involvement; and
- although the collaborative, good-faith approach to resolving external private arrears embedded in the LIA policy remains the most promising way to regain market access post-default, a review of the effectiveness of the LIA policy, including the requirement for the sovereign debtor to negotiate with representative creditor committees, is in order in light of recent experience and given the increased complexity of the creditor base.

A. Restructurings That Are Too Little and Too Late

A review of the recent experience suggests that unsustainable debt situations often fester before they are resolved and, when restructurings do occur, they do not always restore sustainability and market access in a durable manner, leading to repeated restructurings. While the costs of delaying a restructuring are well recognized, pressures to delay can still arise due to the authorities' concerns about financial stability and contagion. Delays were also sometimes facilitated by parallel incentives on the part of official creditors, who accordingly may have an interest in accepting, and pressuring the Fund to accept, sanguine assessments of debt sustainability and market reaccess.

21. Based on the countries reviewed, debt restructurings often took place a considerable period after Fund staff had assessed that the member's debt was no longer sustainable.[14] For example, Belize had a restructuring in 2007, outside of a Fund-supported program, but staff had noted explicit concerns about fiscal and debt sustainability in the 2005 Article IV consultation. In

[14] The review covers sovereign debt restructurings since 2005 in Argentina, Belize, Dominican Republic, Ecuador, Greece, Grenada, Jamaica, Seychelles, and St. Kitts and Nevis.

Seychelles, which defaulted in 2008 and sought financial assistance from the Fund to set the stage for restructuring its debt in 2009-10, staff noted as early as in the 2003 Article IV report that debt was unsustainable. In St. Kitts and Nevis, DSAs in Article IV staff reports going back as far as 2006 showed an explosive debt path for the baseline scenario, although the government's intention to restructure debt was announced only in 2011 in the context of a new Fund-supported program. In several of these cases, a contributing factor to induce debtor countries to approach the Fund and restructure its debt was the loss of market access (proxied by the countries' last sovereign bond issuance on the international capital markets for purposes of this paper, Figure 1).

Figure 1. Public Debt-to-GDP and Timeline of Debt Restructuring and Fund Arrangements 1/

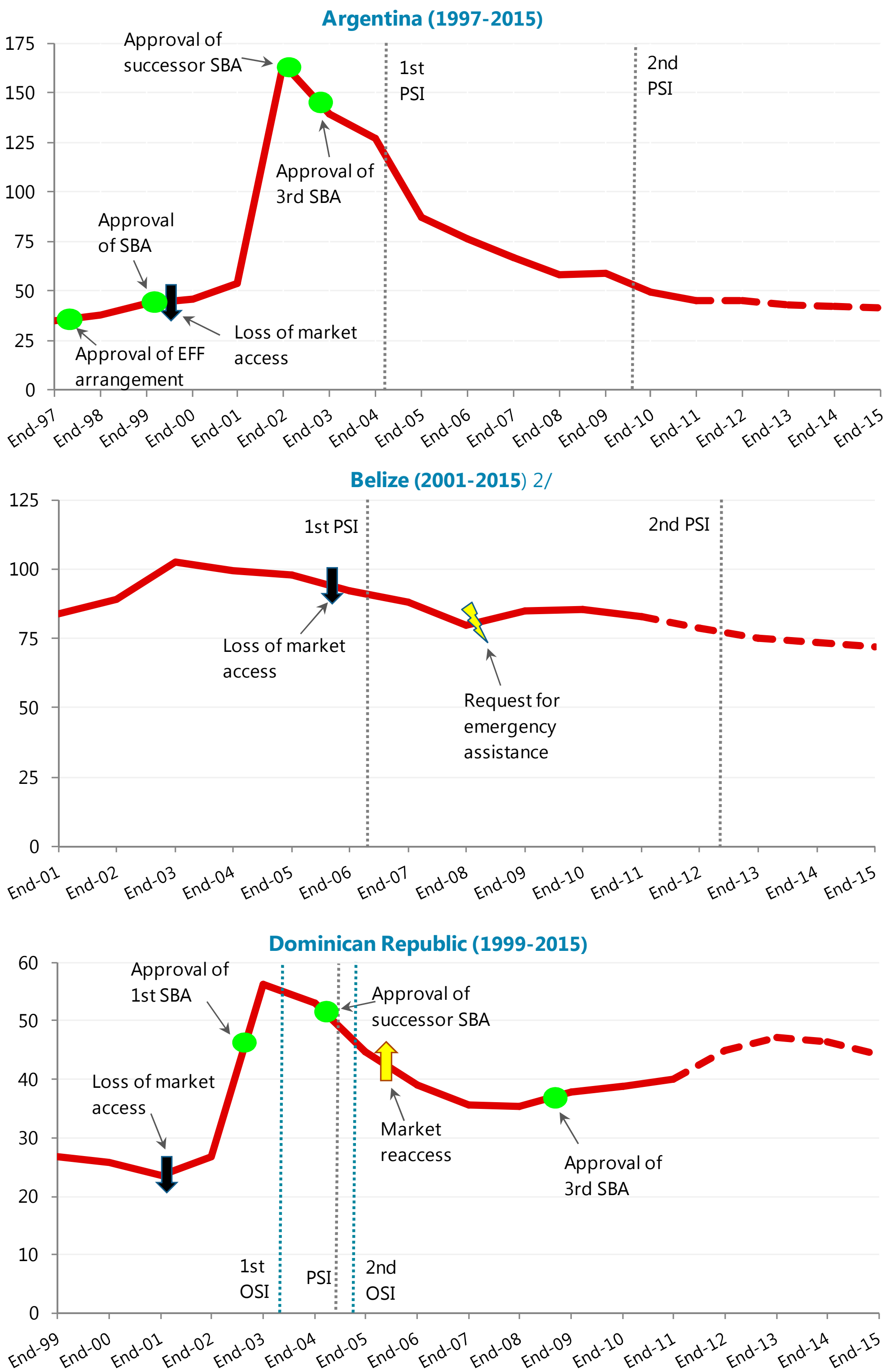


Figure 1. Public Debt-to-GDP and Timeline of Debt Restructuring and Fund Arrangements (continued)

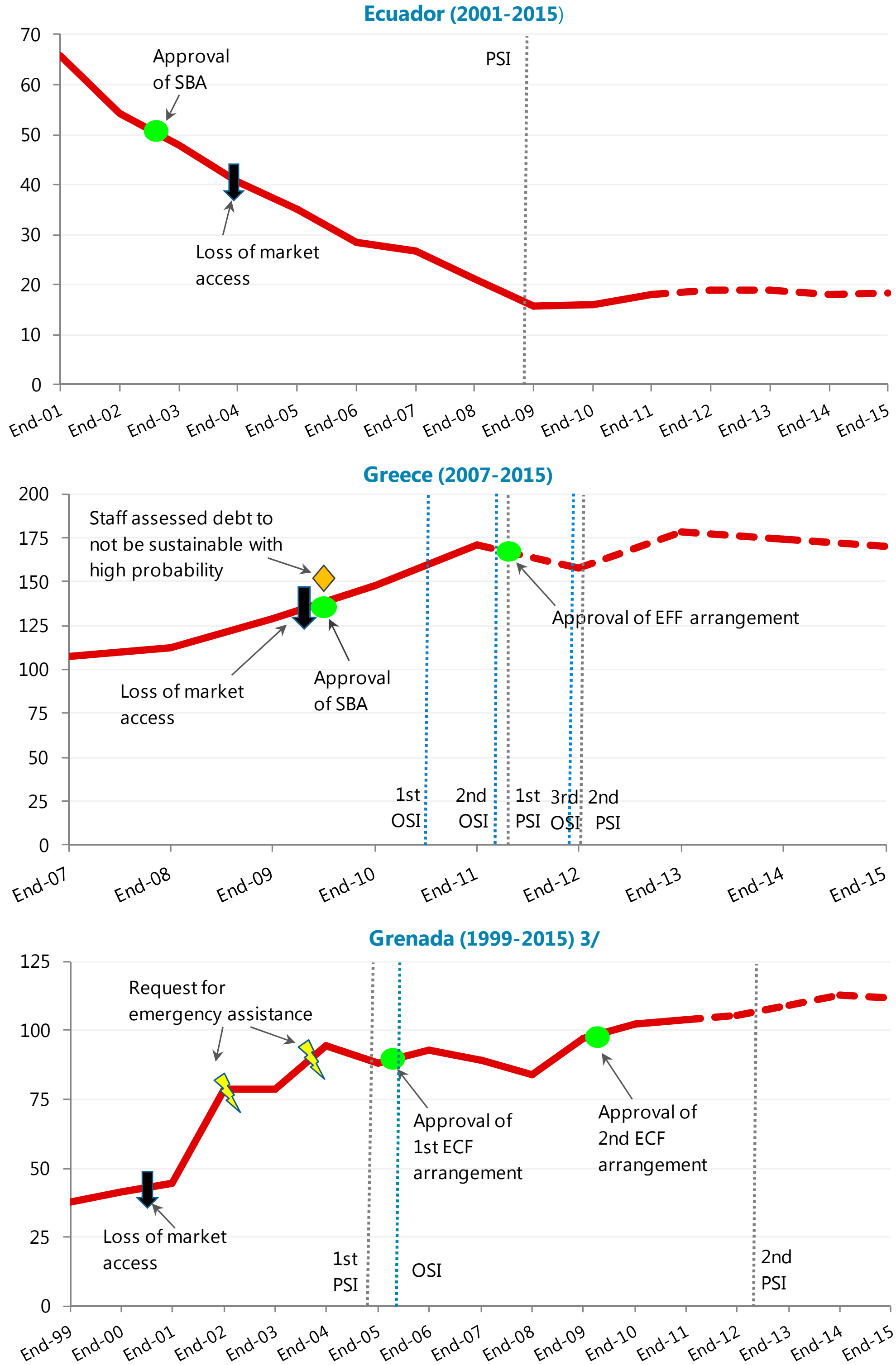
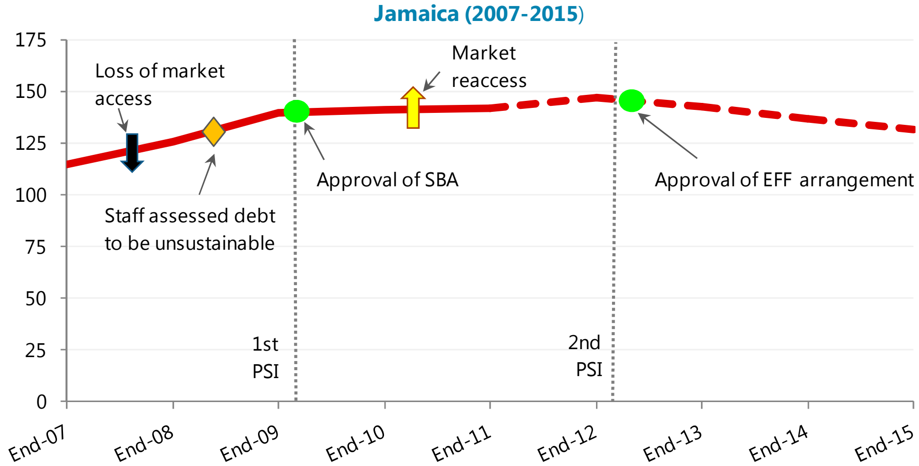
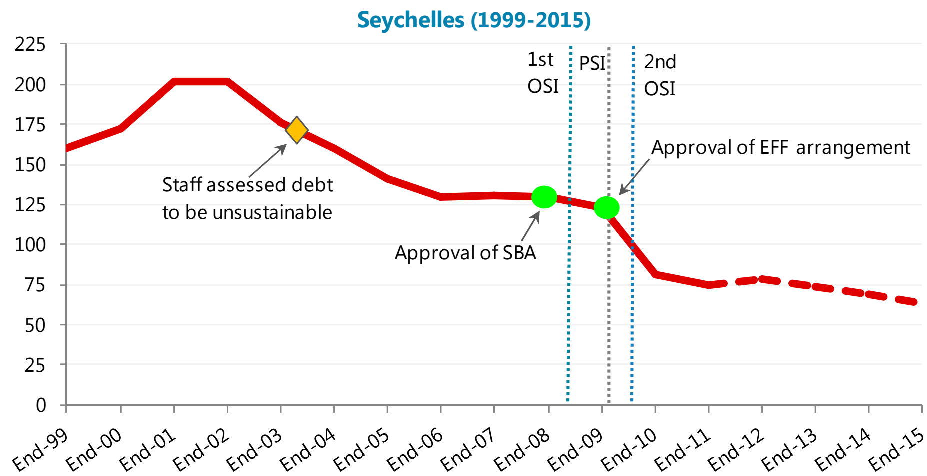
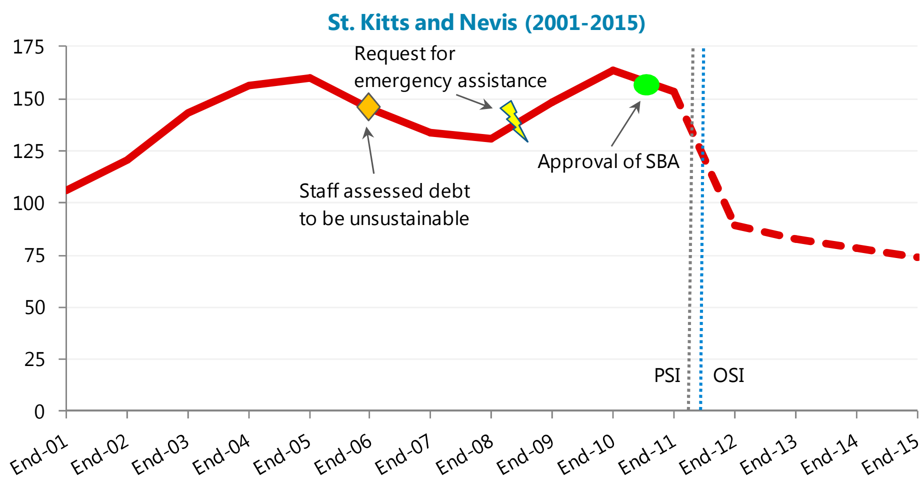


Figure 1. Public Debt-to-GDP and Timeline of Debt Restructuring and Fund Arrangements (concluded)







Sources: Asonuma and Trebesch (2013); Bloomberg; Dealogic; Paris Club; and IMF staff reports.

1/ The PSI line refers to completion of private debt restructurings, and the OSI line refers to Paris Club debt treatments.

2/ The government may have to recognize large additional liabilities associated with the compensation to former owners of the two nationalized companies (including accrued interests), land acquisitions, and arbitration awards. Such liabilities may add up to about 26 percent of 2012 GDP (in gross terms), if mid-point valuation is assumed for the compensation.

3/ The second PSI line refers to the government's announcement of the intention to restructure its public debt in March 2013.

22. The case of Greece is also illustrative of the difficulty of introducing early debt restructuring. Even in the face of a sustained loss of market access, debt restructuring could be delayed because of the ample availability of official financing and the authorities' stated willingness to entertain an unprecedented program of fiscal adjustment. Even under these supportive conditions, however, it was not possible to establish that there was a high probability of debt sustainability as required by the exceptional access policy. The chosen course was therefore to amend the policy to create an exception to the requirement of "high probability" in circumstances where "there is a high risk of international systemic spillovers". Eventually, the planned adjustment proved unfeasible and, despite additional official sector financing on supportive terms, private debt restructuring became unavoidable and was launched in February 2012.

23. Sovereign debt restructuring was not implemented, however, in all cases where debt sustainability was a significant concern. A country under severe stress may be able to avoid a full outright sovereign debt restructuring and restore financial stability with a combination of official financing and adjustment. Although there are no such examples in the post-2005 period considered in this paper, there are earlier cases. For example, Turkey in the early 2000s managed to turn around a near unsustainable debt situation by letting the currency depreciate, sharply tightening fiscal policy and restructuring its banking system. While Turkey was able to avoid an outright debt restructuring operation, the Fund-supported program incorporated a softer form of private sector involvement in the form of voluntary rollover agreements with international bank lenders and measures to bail in bank shareholders to ensure burden-sharing with official lenders. Importantly, throughout the stressful period, Turkey was able to preserve market access albeit at very high interest rates. Future staff work could study such situations in greater depth and contrast them with those where a delay raised the ultimate costs of crisis resolution so as to arrive at a nuanced view of policy implications.

24. Allowing an unsustainable debt situation to fester is costly to the debtor, creditors and the international monetary system. For debtors, a situation of debt overhang depresses investment and growth and creates a sense of financial uncertainty that can raise the eventual magnitude of the debt problem. Moreover, it may exacerbate burden sharing and moral hazard concerns to the extent that continued financing by the official sector allows for the exit of private creditors. Delays that magnify the scale of economic dislocations also tend to reduce the economic value of creditors' claims. In addition, residual private creditors who have not yet been bailed out when the restructuring eventually takes place will have to absorb a greater loss than would otherwise have been the case since the entire burden will fall on a smaller group of creditors. From the Fund's perspective, the delays not only make it more difficult for the member to resolve its underlying balance of payments problems but also create additional financial risks to the Fund as it continues to provide financing to the member.

25. Despite these consequences, pressures to delay a restructuring of unsustainable debt have historically been commonplace. An inclination to delay is no surprise. Debtor governments have feared the economic, financial and political fallout of a restructuring, particularly if the domestic financial sector held a significant amount of public debt. Jamaica's restructuring in 2010, for example, attempted to address a debt level of 124 percent of GDP with a flow rescheduling and no principal haircut, out of financial stability considerations (Table 1).[15] In fact, only the debt exchanges in Argentina, Ecuador, Greece, Seychelles, and St. Kitts and Nevis involved substantive face value haircuts (ranging from 30 to 70 percent).[16] Authorities are also concerned about a restructuring's impact on market reaccess and spillover effects on the private sector.[17] In addition, official creditors have sometimes contributed to delays, out of concern that a restructuring would reduce incentives for the debtor country to adjust, force banks located in official lenders' countries to recognize losses, and trigger market turmoil affecting similarly-situated countries, or to preserve flexibility for the future. Private creditors will also naturally wish to avoid a debt restructuring if at all possible, and will therefore press for a bailout by the official sector. But when a debt restructuring is the only option to deal with a liquidity shock or to restore solvency, e.g., in situations where available financing and policy adjustment have been exhausted, delays end up amplifying the ultimate costs. Also, if authorities come very late to the Fund for financial assistance and have run out of funding, it may not be feasible to execute a preemptive debt restructuring ahead of a Fund arrangement (though a restructuring could be envisioned for completing a subsequent program review).

[15] Risks to the financial sector in Jamaica and St. Kitts and Nevis were somewhat mitigated by the creation of reserve funds to provide temporary liquidity support to solvent financial institutions that might be affected by the debt restructuring.

[16] There may be cases where significant haircuts in NPV terms could be obtained without a face value haircut by lengthening the maturity of debt and applying below-market interest rates. However, in these cases the assessment of the achieved debt relief is very sensitive to the choice of the discount rate. Avoiding a face value haircut may not be appropriate when it is critical to address uncertainty about the member's future viability. The pros and cons of using PV calculations for estimating debt reductions for market access countries undergoing debt restructuring can be studied further in follow-up work.

[17] See Das et al (2012) for a literature survey of the costs and implications of sovereign debt restructurings.

Table 1. Key Features of Recent Debt Restructuring Cases

	Preemptive or Post-Default?	Default Date	Announcement of Restructuring	Start of Negotiations	Final Exchange Offer	Date of Exchange	Total Duration (Months)	Debt Exchanged in US$ bn 1/	Cut in Face Value 2/	Outstanding Instruments Exchanged	New Instruments
Argentina (Dom./Ext. Bonds)	Post-Default	Jan-02	Sep-03	Jan-04	Jan-05	Jun-05	21	81.80	43.4%	152 US$, EUR, Yen, and ARG$ denominated bonds	11 US$, EUR, Yen, and ARG$ denominated bonds
Dominican Republic (Ext. Bonds)	Preemptive		Apr-04	Dec-04	Apr-05	May-05	13	1.10	0.0%	2 Bonds	2 Bonds
Dominican Republic (Loans)	Post-Default	Feb-05	Apr-04	Dec-04	Jun-05	Oct-05	18	0.18	0.0%	Ext. bank loans and arrears	1 Loan
Grenada (Bonds/Loans)	Preemptive		Oct-04	Dec-04	Sep-05	Nov-05	13	0.21	0.0%	7 Ext. Bonds, 9 Dom. Bonds, 2 Ext. Loans, 6 Dom. Loans	1 US$ Bond and 1 EC$ Bond
Belize (Ext. Bonds/Loans)	Preemptive		Aug-06	Aug-06	Dec-06	Feb-07	6	0.52	0.0%	7 Bonds, 8 Loans	1 Bond
Ecuador (Bond buyback)	Post-Default	Dec-08	Jan-09	no neg.	Apr-09	Jun/Nov-09	10	3.19	68.6%	2 Eurobonds	None (cash settlement)
Seychelles (Ext. Bonds/Loans)	Post-Default	Jul-08	Mar-09	Mar-09	Dec-09	Feb-10	11	0.32	50.0%	1 Ext. Bonds, 2 Ext. Loans, Notes	1 Bond, Par notes
Jamaica (Dom. Bonds)	Preemptive		Jan-10	Jan-10	Jan-10	Feb-10	1	7.80	0.0%	Around 350 US$ and J$ denominated dom. bonds	25 US$ and J$ denominated dom. bonds
Argentina (Dom./Ext. Bonds; Reopen)	Post-Default	Jan-02	Apr-10	N/A	Apr-10	Sep-10	5	18.30	43.4%	160 US$, EUR, Yen, and ARG$ denominated bonds 3/	11 US$, EUR, Yen, and ARG$ denominated bonds
St. Kitts and Nevis (Bonds/Loans)	Preemptive		Jun-11	Aug-11	Feb-12	Apr-12	10	0.14	31.8%	11 Ext. Bonds, 2 Dom. Bonds, 4 Loans	1 US$ Bond and 1 EC$ Bond
Greece (Dom./Ext. Bonds)	Preemptive		Jul-11	Jul-11	Feb-12	Mar-12	8	271.22	53.5%	All dom. and ext. bonds, except ECB and CB holdings	20 Bonds, 2 Notes, GDP-linked security
Belize (Ext. Bonds)	Preemptive		Aug-12	Aug-12	Feb-13	Mar-13	7	0.55	10% 4/	1 Bond	1 Bond
Jamaica (Dom. Bonds)	Preemptive		Feb-13	Feb-13	Feb-13	Feb-13	1	8.90	0.0% 5/	28 US$ and J$ denominated dom. bonds	26 US$ and J$ denominated dom. bonds

Sources: Das et al (2012), Sturzenegger and Zettelmeyer (2006), IMF staff reports, and authorities' websites.

1/ Total eligible debt to be restructured in the debt operation.
2/ Figures do not include past due interest.
3/ The reopening of the debt exchange in 2010 involved an exchange of 8 bonds in addition to the original 152 bonds exchanged in 2005.
4/ Missed coupon payments were added to the face value of the new bond (approximately 7 percent of the original principal), resulting in a net face value haircut of about 3 percent.
5/ The exchange was a par for par exchange except for fixed rate accreting notes (FRAN) (20 percent face value reduction targeted to state-owned enterprises).

26. Recent experience has shown that there is an additional factor that may create delay: the fear of contagion. This fear is arguably most acute where the economy of the debtor is closely integrated with other economies. From this perspective, it is interesting to look at the experience with sovereign debt restructurings in currency unions. In recent years, three of the six independent members of the East Caribbean Currency Union (ECCU) experienced a default and debt renegotiation, but this did not put the ECCU at risk, even though a substantial share of the restructured debt was owed to banks in the region. Similarly, there is no indication that the debt restructurings in Côte d'Ivoire, the largest economy of the West African Economic and Monetary Union (WAEMU), substantially affected the union. The risk of contagion was, however, at the forefront in the case of Greece, given the Euro Area's highly integrated debt markets. The concern was that a debt restructuring in one Euro Area member would lead investors to pull out of other Euro Area sovereign debt markets, causing significant damage to bank balance sheets and increasing the tail risks of a breakup of the Euro Area. The fear of contagion was initially amplified by policymakers' ambiguity as to whether debt restructuring would be allowed in the Euro Area (relevant in this regard was the understanding reached in Deauville in October 2010 that debt restructurings would be allowed in the Euro Area but only after 2013). The extent to which the eventual Greek debt restructuring itself led to contagion is a matter for debate. In any event, the official bailout strategy did not prove sufficient to address concerns regarding debt sustainability and did not avert a spreading of the crisis beyond Greece, as the Greek crisis revealed problems in other countries and fundamental problems with the architecture of the Eurozone (including, for instance, the inadequacy of the firewall), which took time to be overcome.

27. Pressures to delay necessary action on debt out of concerns regarding contagion place the Fund in a difficult position. Although contagion can be difficult to analyze quantitatively, there could be circumstances where contagion is a legitimate concern. But while the Fund always takes contagion concerns into account when it designs and implements its lending policies, it should not allow these concerns to override or supersede its primary duty to help members resolve their underlying balance of payments problems. Accordingly, when a member's sovereign debt is unsustainable and there are concerns regarding the contagion effects of a restructuring, providing large-scale financing without debt relief would only postpone the need to address the debt problem. Instead, the appropriate response would be to deal with the contagion effects of restructuring head-on by, for example, requiring that currency union authorities establish adequate safeguards promptly and decisively to cushion the effect of spillovers to other countries (via, e.g., proactive recapitalization of creditor banks, establishment of firewalls, and provision of liquidity support). In the context of the first Greece program, financial assistance was delayed until Greece had lost market access. In response to concerns about possible spillovers from debt restructuring, the Fund lowered the bar for exceptional access (second criterion) by creating an exception to the requirement for achieving debt sustainability *with a high probability* in the presence of systemic international spillover effects. In light of these issues, the modification of the exceptional access policy could usefully be reviewed.

28. When debt restructurings do occur, they often do not restore debt sustainability and market access, leading to repeated restructurings and dependence on official financing. Since a restructuring process is disruptive and costly to the debtor's perceived creditworthiness, it is not desirable to repeat it. However, most of the case studies have shown a prolonged reliance on official financing and repeated debt restructurings. The Dominican Republic, Grenada, and Jamaica all returned for another Fund-supported program after their restructurings and with the initial program going off track quickly. Countries have sometimes sought a subsequent program and/or debt restructuring partly in response to adverse global shocks and natural disasters (e.g., the Dominican Republic and Grenada), suggesting a lack of robustness in their debt positions. Furthermore, five of the nine cases studied (Argentina, Belize, Greece, Grenada and Jamaica) have experienced two or more restructurings of private and/or official claims. Only in a few cases did debt restructuring appear to have restored debt sustainability. In Seychelles, for example, the 45 percent haircut (in nominal terms) on official debt and 50 percent haircut on private bondholders with 100 percent participation helped to reduce public debt from about 130 percent of GDP at end-2008 to 78 percent at end-2012. Seychelles also benefitted from an immediate upgrade in creditworthiness, greatly improving prospects for future market access. In St. Kitts and Nevis, the bond exchange (involving a haircut of 50 percent in NPV terms) and debt-land swap were key in bringing public debt down from about 154 percent of GDP at end-2011 to 92 percent at end-2012. Finally, the time to regain market access depends not only on country-specific factors, but also on global factors. For example, the Dominican Republic was able to regain market access relatively quickly after the restructuring partly due to favorable external conditions.[18]

29. In hindsight, the Fund's assessments of debt sustainability and market access may sometimes have been too sanguine.[19] The existing DSA framework does not specify the period over which debt sustainability or market access is supposed to be achieved (although it is generally understood that debt would be sustainable within a five-year horizon) or how maximum sustainable debt ranges should be derived, leaving this mostly to Fund staff judgment. Sustainability was generally assessed on the basis of an eventual decline in the debt-to-GDP ratio—Argentina, Seychelles and St. Kitts and Nevis were the only three cases that provided for a quick and sizable reduction in the debt-to-GDP levels post-restructuring (Table 2). St. Kitts and Nevis also targeted an explicit debt threshold, i.e., the ECCU debt target of 60 percent of GDP by 2020. Most other cases allowed more than five years for the debt level to fall significantly below safe levels.[20] For example, in Greece the debt-to-GDP ratio in the most recent program projections is not expected to be reduced substantially below 110 percent before 2022, while in the forthcoming Fund-supported program with Jamaica, debt is still projected to remain close to 120 percent of GDP in five years' time. In Grenada,

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[18] *Assessing the Determinants and Prospects for the Pace of Market Access by Countries Emerging from Crises*, and Supplement; and *Assessing the Determinants and Prospects for the Pace of Market Access by Countries Emerging from Crises: Further Considerations*.

[19] This point is discussed in depth in *Modernizing the Framework for Fiscal Policy and Public Debt Sustainability Analysis*, and motivated the strengthened approach to debt sustainability in market-access countries in the latest *Staff Guidance Note for Public Debt Sustainability Analysis in Market-Access Countries*.

[20] The recently issued DSA staff guidance note for market-access countries has provided the scope for assessing debt sustainability over a longer time horizon in some specific circumstances (e.g., in cases of protracted fiscal adjustment). However, it should be noted that the uncertainty associated with the projections of debt burden indicators grows significantly with the projection horizon, thereby progressively weakening the robustness of assessments of sustainability made on this basis

the debt ratio at the end of the five-year horizon actually turned out much higher than staff projections at the time of the restructuring. Also, in Greece, Jamaica (2010) and Seychelles, staff medium-term debt projections have been revised upward substantially within only a few years compared to projections made at the time of the restructurings.

Table 2. Post-Restructuring Outcomes
(Public Debt in Percent of GDP)

	Pre-restructuring	Post-restructuring	5 years post-restructuring			5-year expected debt reduction
			Projection after restructuring	Current projection	Actual	
Jamaica (2013) 1/	147	143	118	...	...	-29
Greece (2012) 2/	165	163	138	153 3/	...	-28
St. Kitts and Nevis (2012) 4/	154	117	85	68 5/	...	-69
Jamaica (2010) 6/	124	140	115	143 1/	...	-9
Seychelles (2009) 7/	129	76	46	64 8/	...	-83
Belize (2007) 9/	92	90	84	...	79	-8
Argentina (2005) 10/	129	78	57	...	49	-73
Dominican Republic (2005) 11/	53	43	37	...	39	-16
Grenada (2005) 12/	130	120	82	...	102	-48

Source: IMF staff reports.

1/ Request for EFF, May 2013.
2/Request for EFF, March 2012
3/ 1st and 2nd reviews under the EFF, January 2013.
4/ St. Kitts and Nevis staff team. The debt-land swap was undertaken by end-2012, helping to reduce debt to 92 percent of GDP (post-restructuring).
5/ 4th SBA review, February 2013.
6/ Request for SBA, August 2010. Data available only for 4 years post-restructuring.
7/ 2010 Article IV Consultation and 2nd SBA review, January 2011.
8/ 6th review under the EFF, January 2013.
9/ 2008 Article IV Consultation, March 2008
10/ 2005 Article IV Consultation, July 2005.
11/ 3rd and 4th SBA reviews, April 2006.
12/ PRGF request, July 2006. Debt at end-2010 would have actually been closer to 120 percent of GDP if based on the old GDP series.

30. In light of the above, a multipronged approach may be needed to ensure timely restructurings. As the reasons for delays and the inadequacy of restructurings are complex, overcoming them likely requires action on several fronts, including a combination of (i) increased rigor and transparency of debt sustainability and market access assessments, (ii) stricter requirements to prevent the use of Fund resources to bail out private creditors, and (iii) measures to alleviate the costs associated with restructurings.

31. There is scope for increasing the rigor of debt sustainability and market access assessments and tightening lending policy requirements. The recently issued guidance note to staff on preparing debt sustainability assessments for market-access countries mandates more systematic assessments and transparent reporting of risks to the baseline, drawing on alternative stress-test scenarios, greater attention to debt levels and risks to funding sources and market access. It also requires systematic assessments of the (economic and political) realism of fiscal adjustments and other assumptions underpinning the DSA. Even with these improvements, debt sustainability assessments will remain judgmental exercises, leaving discretion to the Fund on when to declare debt unsustainable. But the greater standardization of risk assessments and the transparency in reporting embedded in the latest staff guidance note will help limit the use of discretion. Consideration could also be given to removing the exception to the original requirement of "high probability" of debt sustainability under the exceptional access policy when there are risks of systemic spillovers—as argued above, the latter are better addressed by securing cooperation of other institutions or country authorities. In addition, it would be useful to pursue further work on establishing analytical tools for assessing prospects for market access. This in turn could pave the way for stricter evidentiary requirements on prospects for market access in the (third criterion of the) exceptional access policy.

32. There may be a case for exploring additional ways to limit the risk that Fund resources will simply be used to bail out private creditors. For example, a presumption could be established that some form of a creditor bail-in measure would be implemented as a condition for Fund lending in cases where, although no clear-cut determination has been made that the debt is unsustainable, the member has lost market access and prospects for regaining market access are uncertain.[21] In such cases, the primary objective of creditor bail-in would be designed to ensure that creditors would not exit during the period while the Fund is providing financial assistance. This would also give more time for the Fund to determine whether the problem is one of liquidity or solvency. Accordingly, the measures would typically involve a rescheduling of debt, rather than the type of debt stock reduction that is normally required in circumstances where the debt is judged to be unsustainable. Providing the member with a more comfortable debt profile would also have the additional benefit of enhancing market confidence in the feasibility of the member's adjustment efforts, thereby reducing the risk that the debt will, in fact, become unsustainable. While bail-in measures would be voluntary (ranging from rescheduling of loans to bond exchanges that result in long maturities), creditors would understand that the success of such measures would be a condition for continued Fund support for the adjustment measures. Such a strategy—debt rescheduling instead of debt reduction—would not be appropriate when it is clear that the problem is one of solvency in which case reducing debt upfront to address debt overhang and restore sustainability would be the preferred course of action.

33. Measures to alleviate the costs associated with restructurings could also be considered. Any attempt by the sovereign debtor to proactively involve private creditors in a debt restructuring may carry undesirable consequences. These range from delayed market reaccess to impaired financial intermediation and contagion effects. The question therefore is whether the Fund's approach to debt restructuring can be better tailored to cushion some of these effects and thus give confidence to debtors that pursuing a necessary debt restructuring—to address decisively a liquidity or solvency problem that could not be overcome with financing and adjustment alone—will not incur punitive execution costs. In future work, staff could explore ways in which costs of the debt restructuring process can be cushioned so as to encourage the earlier initiation of the restructuring process, for instance by making available Fund financing on supportive terms (e.g., longer maturities), while minimizing moral hazard. Based on a historical review of restructurings, future work could also discuss ways in which financial stability and contagion concerns could be mitigated (e.g.,

[21] For purposes of this paper, the term "bail-in" refers to voluntary creditor involvement in situations where the country has lost market access, which is distinct from the creditor "bail-in" in the context of bank restructurings in Cyprus.

seeking assistance of other institutions and country authorities—especially in currency unions—to enable proactive recapitalization of creditor banks and central bank provision of liquidity).

B. Overcoming the Collective Action Problem

Recent experience indicates that the contractual, market-based approach has worked reasonably well in securing creditor participation and avoiding protracted negotiations. But these episodes have also foreshadowed potential collective action problems that could hamper future restructurings. These problems are most acute when a default has not yet occurred, large haircuts are needed to reestablish sustainability, and sovereign bond contracts do not include CACs. The ongoing Argentina litigation has exacerbated the collective action problem, by increasing leverage of holdout creditors. Assuming there continues to be lack of sufficient support within the membership for the type of statutory framework envisaged under the SDRM, avenues could be considered to strengthen the existing contractual framework.

34. Most of the recent debt restructurings have been conducted preemptively (i.e., launched prior to a default) and have achieved high creditor participation. Among the recent cases, all except Argentina, Ecuador, and Seychelles were preemptive restructurings.[22] Several of these restructurings achieved creditor participation rates above 90 percent (Belize (2007), Grenada, Jamaica, and St. Kitts and Nevis), though in the cases of Belize, Grenada, and Jamaica the restructuring did not effectively restore debt sustainability. While the proportion of holdouts was higher in the post-default case of Argentina (24 percent), it also involved a larger NPV haircut. Greece was *sui generis* in the sense that it achieved very high creditor participation (97 percent), despite being preemptive and targeting a very large haircut (70 percent in NPV terms relative to par).[23] The Fund played an important role in encouraging creditor participation in these restructurings. For instance, in the debt exchanges of the Dominican Republic, Belize (2007), and Jamaica (2010), the Managing Director issued assessment letters emphasizing that a high rate of creditor participation in the debt exchange was critical to the restoration of external sustainability. In the case of Greece, the Fund also noted in a press release prior to the launch of the debt exchange that near-universal participation was important to realize a sustainable debt position, meet financing needs, and ensure continued Fund support. In addition, the Fund staff participated in road shows, at the member's request (e.g., the Dominican Republic), to outline the Fund-supported program and associated financing gaps.

35. Inter-creditor equity issues and litigation have generally not been impediments to successful restructurings. Differential treatment of creditors has been fairly common in recent debt restructurings, reflecting creditor preferences, financial stability, market access, and trade credit considerations. For example, Seychelles offered different terms to domestic and foreign residents to protect the domestic banking sector. Belize (2007, 2013) did not include any domestic instruments in

[22] Ecuador is unique in that it defaulted on two global bonds, representing about 40 percent of total external debt, on the grounds that the debt was illegitimate.

[23] At 9 percent exit yield.

the restructuring. By contrast, the debt exchanges of Jamaica (2010, 2013) affected the entire stock of domestic public debt, while Eurobonds placed in international markets were left out in an effort to preserve market access. The symmetric treatment of bonds in Greece created larger NPV haircuts for holders of shorter-dated bonds. Creditor litigation in the context of bond restructurings has been rare, with the exception of Argentina (2005)—with more than 50 litigation cases filed in the U.S. and the U.K.—as well as Greece (see below).

36. While CACs were useful in recent debt restructurings, other market instruments were also employed to secure high participation. In some cases, including Belize, Seychelles, and St. Kitts and Nevis, the use of CACs enabled full creditor participation and facilitated the debt restructuring process. However, as seen in Greece, the use of CACs did not prevent holdouts, albeit small (3 percent). Other market-based instruments were also used in recent debt restructurings to attract broad creditor participation.[24] For instance, most sovereign debt exchange offers included minimum participation thresholds (ranging from 75 percent to 90 percent);[25] exit consents were used in the Belize and Dominican Republic restructurings of bonds;[26] and most exchange offers included a menu of instruments aimed at individual investor preferences, credit enhancements (e.g., upfront cash repayments, cash-equivalent notes, and add-ons to the new instruments such as GDP-linked warrants), and regulatory sweeteners.

37. The recent Greek debt exchange demonstrates the limitations of CACs in addressing holdout creditors. Of a total value of EUR 205 billion, 7.3 percent of the Greece's debt was governed by foreign law and included CACs. While these CACs were relied upon for purposes of the restructuring of these bonds, holdouts in some bond issues were able to obtain a blocking majority preventing their operation. As described in Box 1, CACs only bind holders on an issue-by-issue basis, and thus it is possible for a creditor or a group of creditors to obtain a blocking position in one or more series, thereby preventing the operation of CACs in that series. Accordingly, while binding a minority within an issuance resolves the collective action problems for the restructuring of that issue, it does not necessarily resolve the collective action problems arising among different bond instruments. Creditors holding a qualified majority of a particular issue that are otherwise willing to reach an agreement with the debtor may be reluctant to pursue a restructuring without an assurance that investors holding other issuances will take similar action. In the case of Greece, of the 36 bonds governed by English law with CACs that were eligible to participate in the debt exchange, only 17 were successfully restructured using CACs. The operation of CACs in the remaining bonds were effectively prevented by holdout creditors, resulting in unrestructured claims of about EUR 6.5 billion, accounting for 30 percent of the total value of debt that were governed by foreign law.

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[24] Bi, Chamon and Zettelmeyer (2011) also argue that relatively low haircuts and legal innovations such as minimum participation thresholds and exit consents have helped coordinate creditors and achieve high participation.

[25] Minimum participation thresholds are designed to assure creditors that the debtor would only proceed with the debt exchange only if a qualified majority of creditors decide to participate.

[26] Exit consents allow a majority of bondholders to modify the nonpayment terms of old bonds in an exchange when accepting and exiting from the exchange offer.

38. In contrast, the statutory approach relied upon by Greece to restructure its domestic debt proved very effective. EUR 184 billion of the debt was governed by the laws of Greece and did not have CACs. The authorities enacted legislation with respect to these bonds that enabled a qualified majority of bondholders to bind all holders of the affected domestic debt to the restructured terms.[27] From a collective action perspective, the key difference between this legislative approach and the contractual approach is that, for voting purposes, it "aggregated" claims across all of the affected domestic law issuances, thereby eliminating the power of a creditor to obtain a blocking position in an individual issuance. In contrast to the foreign law debt, all of the affected domestic debt was restructured as a result of this aggregation feature coupled with a low voting threshold (i.e., two-thirds of aggregated outstanding principal of all affected domestic law bonds based on a quorum of 50 percent).

39. These aspects of the Greek legislation resemble the aggregation features of the SDRM. The key differences between the framework envisaged under the SDRM and the Greek legislation is that the SDRM would be established through a universal treaty (rather than through domestic law), apply to all debt instruments (and not just to bonds governed by domestic law), and be subject to the jurisdiction of an international forum (rather than the domestic courts of the member whose debt is being restructured). At this stage, there does not appear to be sufficient support within the membership to amend the Articles of Agreement to establish such a universal treaty.

40. The question arises as to whether aggregation of claims can be achieved through a contractual framework. Thus far, only four countries have included aggregation clauses in their sovereign bonds: Argentina, the Dominican Republic, Greece, and Uruguay.[28] These clauses, which were first introduced in Uruguay's bonds in 2003, provide the option to amend key terms on the basis of aggregate voting across affected bonds in cases where the amendment affects two or more series of bonds. Specifically, if the sovereign chooses to amend the bonds on an aggregated basis, two voting thresholds must be met: (i) 75 (Greece) or 85 (Argentina, Uruguay and the Dominican Republic) percent of the aggregated outstanding principal of all series to be affected and (ii) 66⅔ percent of the outstanding principal of each individual series to be affected. The latter voting threshold is lower than the typical 75 percent majority needed under CACs (which apply on a series-by-series basis).

41. The effectiveness of such a contractual aggregation voting system is limited in two respects. First, while the required 66⅔ percent threshold for each individual series is easier to achieve than the typical 75 percent threshold, it still enables a creditor to obtain a blocking position with respect to a particular issuance (though it may be more costly to do so). In such cases, a restructuring would be precluded from going forward for *that particular* series, while the restructuring could still be effected for *other series* so long as the two-tier thresholds are met. Second, aggregation applies only to bond series that are issued under the same trust indenture or

[27] Law No. 40/50/2012 enacted on February 23, 2012.

[28] The ESM Treaty requires the inclusion of standardized aggregation clauses in all new euro area government bonds with a maturity above one year starting from January 1, 2013.

trust deed. These limitations are potentially significant. For example, in the case of Greece, if a two–tier voting framework had been used, it is doubtful whether the large bond series that were falling due shortly after the exchange would have voted to participate in the exchange.

42. There is merit in considering whether a more robust form of aggregation clause could be designed and successfully introduced into international sovereign bonds. Further work could be conducted to determine whether aggregated voting in collective action clauses could be made standard practice in new bond issuances, and consideration could be given to the feasibility of replacing the standard two-tier voting thresholds in the existing aggregation clauses with one voting threshold, so that blocking minorities in single bond series cannot derail an otherwise successful restructuring. These provisions would help in the long run, even though legacy debt will not be affected. In particular, removing the individual issuance voting tier would go a long way to reduce the leverage of holdouts. However, and as discussed in an earlier paper, it may give rise to inter-creditor equity concerns where claims being aggregated have different maturities associated with different economic interests.[29] This concern will be more acute in pre-default cases.

43. Recent developments in a long litigation odyssey involving Argentina could have implications for sovereign debt restructurings. Holdout creditors have long pursued Argentina for payment on the full amount of defaulted bonds issued prior to Argentina's 2001 default but not tendered in its 2005 and 2010 debt restructurings. In a recent development, the Second Circuit Court of Appeals in New York has upheld the District Court's interpretation of the *pari passu* clause contained in the defaulted bonds that would require ratable payments to restructured bondholders and holdout creditors.[30] Specifically, the District Court's order, if upheld, would prohibit Argentina from making payments on its restructured bonds unless it pays in full the principal and interest owed and past due on the original unrestructured claims.[31] To enforce the order against Argentina, the District Court's order would also prohibit the trustee and other parties involved in the payment chain from distributing any payments to holders of restructured bonds unless holdout creditors are simultaneously paid in full. This order has been suspended by the Second Circuit Court pending its assessment of the formula that Argentina will be required to use in order to pay the holdouts as well as coverage of the third parties subject to the court order.[32]

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[29] *The Restructuring of Sovereign Debt–Assessing the Benefits, Risks and Feasibility of Aggregating Claims*.

[30] The *pari passu* clause, which is a standard provision in sovereign bond contracts, contains the borrower's promise to ensure that the obligation will always rank equally in right of payment with all of the borrower's other unsubordinated debts. The international financial markets have long understood the clause to protect a lender against the risk of legal subordination in favor of another creditor. As indicated, the Argentine decision construes the provision to require ratable payments.

[31] At this stage, there is no evidence that English courts, which also have jurisdiction over a portion of the sovereign bonds, will be following the approach taken by the recent New York court decisions.

[32] On March 1, the Second Circuit Court ordered Argentina to propose a plan for making "current those obligations on the defaulted bonds that have gone unpaid over the last 11 years." On March 29, Argentina submitted a letter proposing to apply the 2005 and 2010 restructuring terms to the defaulted bonds that are the subject of the *pari passu* claims, and to bring current the interest payments on the original bonds in the same manner provided for in

(continued)

44. The Argentine decisions—if upheld—could exacerbate collective action problems and risk undermining the sovereign debt restructuring process. Until now the legal leverage of holdouts has been limited. While it is relatively easy for these creditors to obtain a judgment against a sovereign after a default, it has been far more difficult to find assets that can be used to satisfy the judgment.[33] However, the Argentine decisions, if upheld, would likely give holdout creditors greater leverage and make the debt restructuring process more complicated for two reasons. First, by allowing holdouts to interrupt the flow of payments to creditors who have participated in the restructuring, the decisions would likely discourage creditors from participating in a voluntary restructuring. Second, by offering holdouts a mechanism to extract recovery outside a voluntary debt exchange, the decisions would increase the risk that holdouts will multiply and creditors who are otherwise inclined to agree to a restructuring may be less likely to do so due to inter-creditor equity concerns.[34] While appearing to recognize that giving greater leverage to holdouts could undermine the debt restructuring process, the court pointed out that such leverage could be contained through CACs. As discussed above, however, the court's confidence in the salutary benefit of CACs appears somewhat optimistic given the ability of holdout creditors to take blocking positions in individual bond issuances. The impact of the Argentine decisions is already being felt. In response to the Argentine decisions, Belize explicitly stated in the February 2013 debt exchange offer as well as the legislation authorizing the terms of exchanged bonds that the *pari passu* clause in the restructured bonds does not require Belize to pay all items of its public debt on a ratable basis to prevent the holdout strategy employed against Argentina and to mitigate litigation risks.[35]

45. Complementing efforts to revamp CACs, the Fund may consider conditioning the availability of its financing more tightly to the resolution of collective action problems. For instance, the use of high minimum participation thresholds could be required in debt exchange operations launched under Fund-supported programs to ensure broad creditor participation. Fund policy encourages members to avoid default to the extent possible, even after restructuring. An expectation of eventually being paid out in full may encourage holdouts. The use of high minimum participation thresholds would help reduce such incentives. The Fund could also routinely issue statements alerting creditors that securing a critical participation mass in the debt exchange would

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connection with those restructurings. On April 19, the holdouts responded by rejecting the Argentine proposal. In addition, the Second Circuit Court has rejected Argentina's petition for a rehearing by the same panel or en banc.

[33] A sovereign's assets are often not commercial in nature and are thus immune from attachment under U.S. law and the law of a number of other jurisdictions. Moreover, the sovereign's assets held offshore are also immune from attachment, even if they are actually used for commercial activity. In addition, a sovereign's financial activities are often carried out through its central bank, the accounts of which are often immune from attachment.

[34] To some extent this concern has already materialized. On March 4, the Export-Import Bank, Taiwan POC commenced an action in New York seeking (i) specific performance of the *pari passu* provision contained in defaulted loans it had extended to Grenada and (ii) an order preventing payment on outstanding bond debt unless Grenada simultaneously makes payments on the defaulted loans. On March 8, Grenada announced its intention to restructure its public debt. While there has been no disposition of the claims at issue, its filing suggests that this remedy may become a feature of sovereign debt litigation going forward in cases where a *pari passu* clause is involved.

[35] Italy also recently modified its Fiscal Agency Agreement to remove the reference to equal and ratable payments and to clarify that the *pari passu* clause requires equal ranking of all unsecured and unsubordinated obligations.

be required for the restoration of external stability—the implication being that failure to meet the established minimum participation threshold would block future program financing, leaving no other option but default and protracted arrears. Also, in pre-default restructurings, where collective action problems are most acute, the Fund could consider setting a clearer expectation (already allowed under existing policy) that non-negotiated offers by the debtor—following informal consultations with creditors—rather than negotiated deals, would be the norm, as in these cases speed is of the essence to avoid a default. These ideas could be explored in future staff work.

46. Finally, the impact of credit default swaps (CDS) on the sovereign debt restructuring process is still not fully tested, given the limited experience in settling such contracts. When Greek sovereign debt concerns intensified in 2010-11, some market participants and policymakers feared that triggering CDS could exacerbate contagion fears and undermine the credibility of the debt restructuring process. However, when the Greek debt exchange was undertaken, the auction process and the settlement of CDS contracts proceeded smoothly and did not pose any significant challenges (see Box 2). Currently, there have only been two examples in which the ISDA auction process has been used to determine the recovery rate for sovereign CDS (Ecuador and Greece),[36] and thus it is still too early to provide a conclusive assessment with regard to the impact of the CDS settlement on the debt restructuring process.

Box 2. CDS Contracts in the Greece Debt Restructuring

It is recognized that sovereign CDS contribute to the efficient functioning of sovereign bond markets, by allowing investors to hedge their credit exposure without requiring a change in their portfolio composition. However, in the context of debt restructuring, creditors who have bought CDS protection may have less incentive to voluntarily participate in a restructuring. Hence, the use of CDS as a hedging instrument could raise the incentive for some creditors to hold out.[37]

The mechanism of CDS determination and auction is established and standardized by the ISDA. Under the ISDA Credit Derivatives Definitions ("ISDA Definitions"), credit events triggering a sovereign CDS are: the failure to pay, moratorium, obligation acceleration, and restructuring. Therefore, either a pre-default debt exchange or a default could trigger a credit event. In general, the debt exchange must bind all the creditors, including those voting against the exchange, in order to be qualified as a "restructuring credit event."

The Greek CDS was triggered following the activation of the collective action procedure and involved a haircut that bound all holders of the affected Greek domestic law debt. While the CDS contracts were smoothly settled, several technical issues were raised that could call into question the efficacy and credibility of the CDS market (IMF, 2013):

- ***Timing of exchange vs. timing of CDS auction.*** Because the CDS auction occurred 10 days after the debt exchange itself, the size of the CDS payout was determined from bids and offers on deliverable bonds that did not include the old Greek government bonds (GGBs), as they had already been exchanged for new GGBs by the time of the auction. Although the CDS payouts (78.5 cent per

[36] For the Ecuador case, see *A Survey of Experiences with Emerging Market Sovereign Debt Restructurings*.

[37] See Hu and Black (2008).

Box 2. CDS Contracts in the Greece Debt Restructuring (concluded)

dollar) were closely aligned with the losses incurred in the debt exchange, this relationship would not necessarily hold and as such may be viewed as a coincidence. If these payouts had been smaller, the CDS protection would have been inadequate to cover all losses incurred by the old GGB holders after the debt exchange, thus casting doubt on the effectiveness of CDS as a hedging tool.

- ***Legal uncertainty of credit event definition.*** As certain official measures taken during the Greek restructuring process were not covered by existing ISDA provisions for CDS contracts and in turn did not trigger a credit event, negative contingencies to investors were increased and consequently the credibility of the sovereign CDS market was undermined. These measures included: (i) the removal of old GGBs ahead of the CDS auction; (ii) the arbitrary change of the covenants of GGBs under domestic governing law to subject these bonds to a collective action procedure; and (iii) the "persuasion" of certain (domestic) investors to accept large haircuts under a "voluntary" PSI agreement.

The change in the Greek bond contracts and legal covenants, along with the occurrence of the CDS auction after the bond exchange, affected adversely the price of the new GGBs. In particular, the price of new GGBs following the ISDA auction declined as investors and banks were reluctant to buy the bonds in the absence of the ability to purchase CDS contracts on the new GGBs. Financial institutions were unwilling to sell CDS contracts on the new bonds during the 60-day "look-back period", in which CDS payments normally apply for credit events occurring in the past.

C. Clarifying the Framework for Official Sector Involvement

The growing role and changing composition of official lending raise a number of issues in the context of the application of the Fund's lending and restructuring policies. These issues could be discussed further in follow-up staff work.

47. First, heavy reliance on official lending may inhibit spontaneous market access as private creditors may believe they will be subordinated to official creditors. Whether or not a debt restructuring is required, a condition for exceptional access (third criterion) is that the member "has prospects for gaining or regaining access to private capital markets within the timeframe when Fund resources are outstanding". As discussed in Section II, the assumption underlying this criterion is that, in order for a member to address its underlying problems within a timeframe that enables the Fund to be repaid, the member will need to regain access to capital markets within the medium term. The question is how the market reaccess test of external viability enshrined in the exceptional access policy should be evaluated in cases where official lenders make open-ended commitments to support countries until they regain market access, as in the case of Greece. If commitments from official lenders are conditional, a case could be made that they should be linked explicitly to the authorities' efforts to cooperate with the Fund in the context of a program, rather than to the achievement of *ex ante* program targets, as the latter may evolve over time in response to developments.

48. Second, there is no specific standard for securing program financing commitments from non-Paris Club creditors. The application of the Fund's policy of non-toleration of arrears to official bilateral creditors is centered on the Paris Club conventions, and there have been few problems when the claims that needed rescheduling were owed to Paris Club creditors. In the case where a Paris Club Agreed Minute does not exist, tacit approval of each official bilateral creditor of a member is needed for the Fund to provide financing. This has led to uneven practices across country cases and additionally creates safeguards risks to the Fund (see Box 3). Consideration will need to be given as to how to adapt current Fund policy in this area—which relies on the Paris Club conventions—in an environment where a growing number of creditors are non-Paris Club members.

Box 3. Financing Assurances in Previous OSI Cases

The Fund has sought strong assurances in the context of large official debt relief operations within the Paris Club framework.

- ***Poland (1990)***. In Poland, a pre-Evian case of large debt reduction provided by the Paris Club, the Fund required a press release from the Club in advance of an SBA program review that contained specific information on the amount and timing of debt reduction to be provided by official creditors.

- ***Egypt (1991).*** In Egypt, also a pre-Evian case, the Paris Club issued a press release prior to Fund disbursement though the language in the press release was less specific than in Poland. In this case, the staff report contained language that the Fund would require written assurances from creditors for continued financial support.

The Fund has also required specific assurances from non-Paris Club members that had significant claims on a debtor country.

- ***Iraq (2004).*** Ahead of EPCA arrangement approval, the Managing Director convened a meeting of the Executive Directors representing Iraq's major creditors to obtain confirmation that their authorities accepted the language on specific assurances to be included in the staff report, summing up, the Chairman's concluding remarks and press release. As indicated in the excerpt of the press release below, these assurances explicitly recognized the Fund's preferred creditor status:

    - "In addition to risks related to program implementation, external developments, such as lower oil prices, and the hazardous security situation, Iraq has an unsustainable level of external debt. In order to allay the risks to the Fund from lending to Iraq under these circumstances, the bulk of Iraq's official bilateral creditors—through the relevant Executive Directors—have reaffirmed their recognition of the Fund's preferred creditor status in respect of the drawing by Iraq under the EPCA and, similarly, have indicated that they are willing to make their best efforts—given Iraq's continuing cooperation with the Fund—to provide debt relief on appropriate terms to ensure the timely repayment to the Fund of the amounts provided under the EPCA, in accordance with the Fund's preferred creditor status. They have also confirmed that during the period of the economic program supported by the EPCA, a deferral will be in place with respect to those obligations of Iraq that are falling due to them."

- ***Seychelles (2008).*** Seychelles sought debt reduction from Paris Club creditors under the Club's Evian Approach. In this case, South Africa, a large non-Paris Club creditor, participated in the Paris Club negotiations, and was a signatory of the Agreed Minutes. The Fund required that the Paris Club's Agreed Minute and subsequent IMF staff reports acknowledge upfront that debt was unsustainable and include specific information on the timing and amount of debt reduction to be provided by creditors.

Box 3. Financing Assurances in Previous OSI Cases (concluded)

- ***Greece (2012).*** Approval of the Greece EFF arrangement relied on a commitment from the European partners to "provide adequate support to Greece during the period of the Greek policy program and beyond for as long as it takes to regain market access." In light of the elevated risks in the Greek program at the time of the first and second reviews, stronger assurances were provided through Eurogroup statements and also reflected in the Grays of European directors: "Euro area Member States have respected their commitment to help Greece and remain committed to providing adequate support to Greece during the life of the program and beyond until it has regained market access, provided that Greece fully complies with the requirements and objectives of the adjustment program." The Grays also acknowledged and upheld the Fund's preferred creditor status. Financing assurances from Euro area member states were less clear in the Greece 2010 SBA though that program at its inception did not envision debt restructuring and a need for OSI.

49. Third, arrears to private and official creditors are currently treated asymmetrically under Fund policy. Private external arrears are tolerated but arrears to official bilateral lenders are not.[38] This subjects the Fund to the risk that it could not assist a member in need due to one or more holdout official bilateral creditors who seek favorable treatment of their claims. Consideration could be given to extend the LIA policy to official bilateral arrears and in that context clarify the modality through which assurances of debt relief are provided by (non-Paris Club) official lenders. Another possibility would be for the Paris Club to extend its membership to all major lenders, so as to allow the Fund to rely on the Paris Club conventions with respect to financing assurances and arrears. However, it is uncertain whether the Club could achieve such an expansion.

D. Broader Stocktaking of the LIA Policy

Over the years, a number of issues have arisen with respect to the application of the LIA policy, in particular in the case of Argentina. A review of the LIA policy to assess its objectives and effectiveness is thus warranted.

50. The application of the LIA policy appears to have been uneven. As noted in Section II, the LIA policy permits the Fund to provide financing to a member in arrears to private creditors provided that the member is making good faith efforts to reach a collaborative agreement with its creditors. The policy establishes a number of underlying guiding principles to assess whether the good-faith effort criterion is observed. In four of the Fund-supported programs reviewed (Dominican Republic, Grenada, Seychelles, and St. Kitts and Nevis), the LIA policy was considered met. In all these cases, staff generally judged that the authorities were engaged in good faith efforts to reach a collaborative agreement with creditors. However, it was not always clear how a member's adherence to the underlying guiding principles of the good faith criterion should be assessed. This was reflected in

[38] This paper does not discuss Fund policy regarding the treatment of arrears of HIPC countries to creditors that have not yet provided debt relief on HIPC comparable terms. This issue could be examined in subsequent work.

inconsistencies in the coverage of debtor-creditor relations in Fund staff reports and, in some cases, the assessment was rather cursory.

51. The case of Argentina raises important questions regarding the effectiveness of the LIA policy:

- The Fund-supported programs in 2003 did not contain a fully quantified medium-term fiscal framework to help guide lending decisions. Rather, this element of the program was left to be negotiated between Argentina and its private creditors, thereby reducing the central role that the Fund normally plays in setting the macroeconomic framework and, by implication, the resource envelope that determines the terms of the eventual debt restructuring.

- Issues also arose with respect to how the LIA policy required Argentina to engage with its private creditors. Under the LIA policy, the authorities were expected to negotiate with creditor committees that were judged to be representative and formed in a timely manner.[39] Although there were over thirty creditors' committees, the Fund assessed that the Global Committee of Argentina Bondholders (GCAB) represented about one-half of Argentina's external private debt, and was therefore representative for the purposes of the LIA policy. In the end, however, no constructive dialogue was observed and the authorities presented a non-negotiated offer, which eventually led to a restructuring of eligible debt and past due interest of about two-fifths of total debt, more than three years after the default.

52. It is thus time to take stock of the application of the LIA policy in light of the recent experience. The collaborative, good-faith approach to resolving external private arrears embedded in the LIA policy remains the most promising way to regain market access post-default. Nevertheless, a review of the LIA policy could assess whether the policy has met its objectives and, in particular, whether the requirement for the sovereign debtor to negotiate with representative creditor committees remains appropriate in light of the increased complexity of the creditor base. In particular, over the years creditors have increased in number and become more dispersed, while having different accounting rules (e.g., book value versus mark-to-market) and holding patterns and incentives (e.g., short-term creditors versus those holding to maturity), especially when creditors enter the debt market at different prices. It may be difficult for any creditor committees to be deemed representative of such a wide diversity of interests.

[39] Creditor committees were formed to negotiate with debtors in a number of preemptive cases (e.g., Belize, Grenada, Greece, and St. Kitts), although in such cases, Fund policy did not insist on any particular form of dialogue between the debtor and its creditors, even if a creditor committee was formed that was deemed to be representative.

IV. RECENT PROPOSALS FOR ORDERLY DEBT RESTRUCTURINGS

53. The recent Greek debt restructuring has revived the debate over the adequacy of the existing market-based debt resolution approach. In particular, several proposals have been put forward with a view to establishing (formal or informal) statutory or institutional frameworks to overcome collective action problems and facilitate a timely and orderly debt restructuring. Also, the IIF recently adopted an Addendum to its Principles that takes into account the experience of the Greek debt restructuring.[40]

European Crisis Resolution Mechanism

54. The proposal for a European Crisis Resolution Mechanism (ECRM) by Bruegel advocates an EU-wide statutory, legally binding regime.[41] The ECRM, which is intended to make use of the existing EU institutions, would be established by an international treaty or an EU directive. The ECRM would consist of three building blocks: a financial body for providing interim financing (e.g., the ESM); an economic body to assess debt sustainability and oversee the economic adjustment of the debtor country (e.g., European Central Bank or European Commission); and a legal body to resolve disputes (e.g., European Court of Justice). Drawing from the SDRM concept, the ECRM could be initiated upon a debtor country's request, impose a stay of all litigation against the debtor country, enable a super-majority of bondholders to cram down dissenting creditors, and provide for aggregated voting across all creditors' claims. A key difference from the SDRM is that the ECRM does not envisage a formal Fund role in the mechanism.

Proposal to Amend the ESM Treaty

55. Another recent proposal envisages an amendment of the ESM treaty to address holdout creditors by minimizing litigation risks.[42] Under this proposal, the ESM treaty would be amended to immunize a debtor country's assets from attachment by litigious holdout creditors, thus deflating creditor expectations that staying out of an ESM-supported sovereign debt restructuring will lead to a preferential recovery for the holdouts.[43]

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[40] Some of these proposals are described in detail in Das et al (2012).

[41] Jürgen von Hagen, Jean Pisani-Ferry, André Sapir, Francois Gianviti, and Anne O. Krueger, *A European mechanism for sovereign debt crisis resolution: a proposal* (November 9, 2010)

[42] Buchheit, Gulati, and Tirado, 2013, *The Problem of Holdout Creditors in Eurozone Sovereign Debt Restructurings*.

[43] To increase the potency of such a measure, the proposal also calls for enacting comparable immunities in U.K. and other countries' domestic law. A similar approach was adopted by the United Nations Security Council under Resolution 1483 in May 2003 to support Iraq's efforts to restructure around US$140 billion of external debt. The Resolution provides that all petroleum or gas assets originating from Iraq, as well as any proceeds thereof, and the Development Fund for Iraq shall enjoy privileges and immunities equivalent to those enjoyed by the United Nations against any form of attachment, garnishment or execution (http://www.un.org/ga/search/view_doc.asp?symbol=S/RES/1956%282010%29).

Sovereign Debt Tribunal (SDT)[44] / Fair and Transparent Arbitration Process (FTAP)[45]

56. These proposals rely on institutionalized or ad hoc arbitration frameworks to support restructuring of sovereign external debt. The SDT envisages a tribunal of arbitrators that could be activated through special clauses in future sovereign debt contracts. Once established, its procedures may eventually create "spillover effects on the legal treatment of other state obligations," even if some do not contain arbitration clauses. The FTAP is similar to the SDT, but less institutionalized. It proposes an ad hoc arbitration mechanism that would rule on a case-by-case basis. Debtors and creditors would propose two arbitrators each, who would jointly choose a fifth arbiter to head a panel.

International Debt Restructuring Court (IDRC)[46]

57. A proposal by a group of UN experts envisages the establishment of an International Debt Restructuring Court (IDRC). The court would ensure that agreed international principles regarding the priority of claims, size of necessary overall write-downs, and the burden sharing of write-downs are followed. It could differentiate between distinct debt categories, which might include government, government guaranteed, and government-acquired private debt, so as to make transparent the actual effective liabilities of the sovereign. It could also determine what debts could be considered "odious," and it would be able to grant potential private or public creditors authority to extend "debtor in possession" financing, as in corporate restructurings. National courts would have to recognize the legitimacy of the international court, and both creditors and debtors would "therefore" follow its rulings. The court would be part of a more permanent debt mediation and arbitration mechanism created under UN auspices with technical support from the Bretton Woods institutions; however, it would be independent from those institutions.

Sovereign Debt Forum (SDF)[47]

58. A non-statutory and non-institutional proposal has been advocated through the creation of a Sovereign Debt Forum (SDF). It would comprise a neutral standing body created by informal consensus and will bring together debtors, creditors, and international institutions. The SDF would be expected to enable early, discreet consultation and information sharing between distressed sovereigns and their creditors to speed the process by which a sovereign is returned to solvency,

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[44] Paulus, Cristoph, 2010, *A Standing Arbitral Tribunal as a Procedural Solution for Sovereign Debt Restructuring*, in Braga, Carlos A. Primo and Gallina A. Vincelette (eds.), *Sovereign Debt and the Financial Crisis: Will This Time Be Different?(* Washington: World Bank Publishers).

[45] Raffer, Kunibert, 2005, *Considerations for Designing Sovereign Insolvency Procedures*, Law, Social Justice & Global Development Journal.

[46] United Nations, 2009, "Recommendations of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System," A/63/838. (New York N.Y.: United Nations).

[47] See Gitlin and House, *A Renewed Proposal for a Sovereign Debt Forum*, March 27, 2013.

stability and growth. It would also aim to help build balanced consensus on needed macro adjustments and the treatment of any relevant debt, as well as protect institutional memory and build precedent.

***Automatic maturity extension proposal*[48]**

59. This proposal aims to reinforce the European Stability Mechanism (ESM) through supplementary bond issuance terms. In an effort to sustainably enhance the stability of the currency union, the proposal suggests that the future ESM be accompanied by the compulsory addition of a trigger clause to the issuance terms of Euro Area bonds stipulating that maturities will be automatically extended by three years in the event of assistance being granted by the ESM. Furthermore, extending the maturity would not constitute a credit event with all of the associated negative consequences. This addition of a trigger clause was envisaged as an adequate safeguard of the currency union for the future.

Addendum to the IIF Principles

60. In 2006, the Institute of International Finance (IIF) published a set of non-binding Principles for best practice in debtor-creditor relations, with the view to improving the debt restructuring and crisis resolution processes.[49] The Principles are a market-based, voluntary, and flexible framework for enhanced creditor-debtor coordination and apply to all sovereign debtors.[50] When the Principles were drafted, the Fund left their specifics to sovereign debtors and their creditors, since the effectiveness of voluntary rules hinges critically on the negotiation among the parties involved.[51]

61. While the Principles are broadly consistent with existing Fund policy expectations, there are notable differences with Fund policies. For instance,

- The Principles note that early *negotiations* with a creditor committee should take place when a default has occurred. The LIA policy, however, provides for formal negotiations with a creditor committee only if the case is complex, the creditor committee is representative, and it has been established on a timely basis. More generally, when arrears arise, the Fund's LIA policy embeds the expectation that the debtor will engage creditors in collaborative and good faith discussions.

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[48] Weber, A.A., J. Ulbrich, and K. Wendorff, 2011, *Safeguarding financial market stability, strengthening investor responsibility, protecting taxpayers: A proposal to reinforce the European Stability Mechanism through supplementary bond issuance terms*. http://www.bundesbank.de/Redaktion/EN/Kurzmeldungen/Current_issues/Archive/2011_03_03_european_stability_mechanism.html

[49] The IIF established the Group of Trustees to serve as the guardian of the Principles. The Group of Trustees consists of 45 current and former leaders in global finance.

[50] Including debt restructuring by banks or other non-sovereign entities in which the sovereign plays a major role in setting the legal framework.

[51] IMF, *Progress Report to the International Monetary and Financial Committee on Crisis Resolution,* April 12, 2005.

- The Principles do not cover voluntary standstills on litigation by creditors represented on the committee, which is included in the LIA policy.

- The Principles call for a resumption of partial debt service, to the extent feasible, as a sign of good faith to facilitate a restructuring. Such payments are not a feature of the Fund's good faith criterion under the LIA policy. More generally, the program adjustment and financing parameters determine the envelope of resources available for payments to creditors.

- The Principles suggest that when a sovereign debtor is engaged in a restructuring with private creditors, a restructuring should also be sought from all official bilateral creditors. This could prove controversial and in practice debt restructurings have not always involved official bilateral claims.

62. The IIF supplemented its Principles to reflect the experience of the Greek debt restructuring, by adopting an Addendum in October 2012. Although the Addendum contains certain elements that can contribute to financial stability, it advocates a number of positions that are not fully consistent with existing Fund policies and practices on sovereign debt restructuring:

- ***Involvement in debt sustainability analysis.*** The Addendum encourages greater involvement of private creditors in setting the macroeconomic and policy parameters that underlie the debt sustainability analysis (DSA) in Fund-supported programs. The Fund welcomes a constructive engagement between the debtor and its creditors, including creditors' provision of inputs on the adjustment strategy. However, a formal involvement of the private sector in the preparation of the DSA would run against the need to preserve the independence of the Fund and, in fact, it could undermine its credibility in setting achievable policy parameters for the country, given that the private sector often has different interests and objectives. At the request of the member, Fund staff may explain the basis of the macroeconomic framework and DSA to creditors, but formulation of the framework and DSA is determined by the Fund, in discussions with the debtor.

- ***Formation of a creditor committee.*** While the Principles allowed a creditor committee to be formed on a case-by-case basis, the Addendum proposes that private creditors organize themselves in a broadly-based representative creditor committee as early as possible for the negotiation of a debt restructuring. The Fund encourages its members to engage in a collaborative process with their creditors when seeking a restructuring of their debt, including engaging in an early dialogue with creditors, sharing non-confidential information with all creditors on a timely basis, and providing creditors with an early opportunity to give input on the design of restructuring strategies and instruments. Beyond that, the Fund leaves the specific details of the debt restructuring strategy to be determined by the debtor, including the formation of a creditor committee.

- ***Inter-creditor equity.*** The Addendum proposes that the sovereign debtor should treat fairly and provide comparable treatment to all creditors, and thus no creditor or creditor group should be excluded *ex ante* from participating in a debt restructuring. It also suggests that any exceptions to the inclusion of a specific group of creditors in a debt restructuring should be discussed and agreed by all creditors. The Fund is of the view that, while adequate fairness of treatment among creditors should be sought in any debt restructuring in order to secure high rates of participation, the design of the debt restructuring strategy should be left to the negotiations between creditors and the debtor. In some cases, creditors may accept some differentiation in the treatment of their claims, either to better fit with individual creditor preferences or on the grounds that this would help limit the extent of economic dislocation, maintain market access, and preserve financial stability.

Given these and other differences between the Principles and its Addendum and the Fund's own policy framework on sovereign debt restructuring, the Fund cannot endorse them.

63. Fund staff monitors developments of debt resolution initiatives and the actual applications of the Principles and its Addendum to keep the Executive Board informed. Fund staff also encourages an open communication with the IIF on such matters of mutual interest.

V. ISSUES FOR DISCUSSION

64. Based on the review of relevant Fund policies in light of the experience of recent debt restructuring cases, this paper has identified four issues which could usefully be explored in subsequent work. Examining these issues would help address emerging gaps in the Fund's current legal and policy framework for sovereign debt restructuring. If Directors support work in the areas listed below, staff will prepare follow-up papers to propose specific options for the Board's consideration to improve the Fund's legal and policy framework.

- Do Directors agree that it would be useful to better understand why debt restructurings have often been delayed and to examine options for making restructurings more timely and effective at restoring sustainability and market access?

- Do Directors agree on the need to consider options to make the current contractual, market-based approach to debt restructuring more effective in overcoming collective action problems, especially in pre-default cases?

- Do Directors see merit in clarifying the framework for official sector involvement in light of the growing role and changing composition of official lending?

- Do Directors agree that, while the collaborative, good-faith approach to resolving private arrears embedded in the LIA policy remains the most promising way to regain market access post-default, a review of the effectiveness of the LIA policy is warranted in light of the recent experience and increased complexity of the creditor base?

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Annex I. Fund Policies on Financing Assurances and External Arrears

1. The Fund's financing assurance policy operates in tandem with the Fund's policy on external payments arrears in addressing the underlying balance of payments problem manifested by arrears. Since there are limits both to the degree of policy adjustment that could be undertaken by a member and the amount of financing that could be provided by the Fund, burden sharing between official and private creditors has become an important element of the financing assurances policy. Experience shows that creditors would be willing to participate in burden sharing by providing the necessary support to fill any financing gaps only if the Fund-supported program provided for the elimination of arrears owed to them. Moreover, the member's ability to repay the Fund would be strengthened if the member were making progress in normalizing relations with its creditors, and if the terms of new financing and/or refinancing were consistent with the member's return to external viability.[1]

Financing Assurances Policy

2. The Fund's financing assurances policy aims at ensuring consistency of Fund financing with the member's return to viability to give the Fund assurances that it can be repaid by the member within the medium term. The financing assurances policy was developed during the 1980s debt crisis where commercial banks were trying to limit their exposure to heavily indebted countries and the Fund could no longer assume that these banks would be willing to assist spontaneously in the financing of Fund-supported programs for these countries. When the policy was initially defined in early 1980s, it required that, as prior condition to the availability of Fund assistance, other creditors (official and private) need to furnish specific assurances that they would provide the necessary support (either through new loans or refinancing) to fill the estimated gaps in the financing of the program on terms consistent with the member's return to external viability.[2] In the late 1980s, the Fund recognized that strict adherence to the receipt of explicit financing assurances effectively gave commercial banks a de facto veto over availability of Fund financing, thereby undermining the Fund's ability to provide timely assistance to members that were making efforts to address their balance of payments problems and thereby jeopardizing the adjustment process. To realign the policy with its underlying principles and objectives, the Fund decided to modify the financing assurances policy by allowing the approval of an arrangement before banks had provided assurances as to their willingness to support a financing package consistent with the

[1] While in principle the application of the Fund's policies on arrears and financing assurances require that all private creditors participate in burden sharing, private creditors with relatively small exposure (e.g., uninsured suppliers) are excluded from this requirement for practical reasons.

[2] In practice, the Fund required a formal confirmation from a critical mass of banks through their advisory committees. A critical mass was considered to be the level of participation that made the implementation of financing agreement virtually certain. The share of banks that constituted a critical mass was a matter of judgment on a case-by-case basis, but generally over 90 percent.

assumptions of the program.[3] This modification also necessitated a revision of the arrears policy by introducing the LIA policy to allow for the accumulation of arrears to external private creditors as discussed above.

3. Under the financing assurances policy, the Fund needs to be satisfied that program financing is adequate to fill financing gaps: (i) during the program period to ensure viability as well as (ii) during the post-program period to ensure that the member is in a position to repay the Fund. In practice, the condition that the program be "fully financed", namely at a minimum, on approval of a Fund arrangement, requires the following judgments to be made: (i) "firm commitments" of financing must be in place for the first 12 months of the arrangement, and (ii) there must be "good prospects" that there will be adequate financing for the remaining program period beyond the first 12 months. During program reviews, assurances on full financing of successive 12-month periods beyond the initial 12 months (or whatever period is left under the arrangement) must be ascertained. Specifically, the "good prospects" must become "firm commitments" or actual financing.

4. In programs involving debt restructuring, the financing assurance policy does not prescribe the allocation of financing (through new financing and/or restructuring) to be provided between official and private creditors. In case the financing gap cannot be filled with fresh resources (from the official and/or private sector), the Fund's policy on financing assurances explicitly encourages "the restructuring of creditors' claims on the country on terms compatible with balance of payments viability." Assurances about debt sustainability and financing in these cases are obtained as follows:

- *Bilateral official creditors.* The Fund has considered that financing assurances is received from Paris Club creditors if there is an expectation that the member will reach an Agreed Minute with the Paris Club creditors shortly after approval of an arrangement or completion of a review. Relying on the Paris Club's comparability of treatment, the Fund assumed that non-Paris Club bilateral creditors will restructure the member's debt on similar terms as the Paris Club creditors. The Fund required additional assurances from official creditors in some cases involving arrears in the context of large official debt relief operations. These assurances include explicit recognition of the Fund's preferred creditor status, inclusion in the Agreed Minute of specific information on the timing, amount and modalities of debt reduction to be provided by official creditors, and written assurances from creditors for their continued financial support.[4]

[3] To address concerns about the adequacy of safeguards, the modified policy provides that such approval can be granted only in cases where (i) prompt Fund support is judged to be essential for program implementation, (ii) negotiations between the member and its creditors have begun, and (iii) it can be expected that a financing package consistent with external viability will be agreed within a reasonable period of time. Progress in the negotiations with bank creditors would be closely monitored.

[4] In all these cases, a significant portion of the agreed official debt relief was delivered in tranches upon satisfactory completion of program milestones to preserve incentives for adjustment efforts.

- *Private creditors.* To the extent that the Fund determines that a contribution from the private sector in the form of debt restructuring will be needed to restore debt sustainability, it may provide financing only if it has adequate assurances that such a restructuring will be successful. Such assurances are obtained by a judgment that a credible process for restructuring is underway and will result in sufficient creditor participation to restore debt sustainability and close financing gaps within the macroeconomic parameters of the program, after taking into account official sector commitments (see above).[5]

Arrears Policy

5. The Fund's general policy on non-toleration of external payments arrears is premised on the destructive nature of external payments arrears. The legal basis of the policy is found in Article V, Section 3 which directs the Fund to adopt policies on the "use of its general resources that will assist members to solve their balance of payments problems in a manner consistent with the provisions of the Articles and that will establish adequate safeguards for the temporary use of the general resources of the Fund". Because this language incorporates by reference all of the relevant provisions of the Fund's Articles, including the Fund's purposes, the basis for this policy is relatively broad.

6. Over the years, two principles have had an important effect on the scope and objectives of the Fund's arrears policy. First, the policy was conceived as a means of helping ensure that members resolve their balance of payments problems "without resorting to measures destructive of national and international prosperity" (Article I(v)). When the policy was initially defined in 1970,[6] the Fund recognized that incurrence of arrears was destructive to a member's own national prosperity, the international payments and credit system and the member's capacity to repay the Fund, and was an inappropriate way to address balance of payments problems. By providing support for programs that call for the elimination of existing arrears and the non-accumulation of new arrears, the Fund assists the member to return to external viability and contributes to the orderly functioning of international capital markets. Second, the policy is designed to ensure adequate safeguards for the temporary use of the Fund's resources by limiting the ability to achieve financing through the accumulation of arrears. Additional financial support from creditors was viewed as an essential component to Fund support.

7. In its original conception, the scope of the Fund's arrears policy was limited in two important respects. The jurisdictional coverage on external payments arrears was limited to

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[5] Relevant considerations to form such judgment include the engagement of legal and financial advisors by the member, the launching of consultations with creditors, and the design of the debt restructuring strategy, including the terms of the new instruments and use of inducements for creditor participation.

[6] At that time, the policy focused on the jurisdictional arrears which are external payment arrears arising from exchange restrictions subject to Article VIII, Section 2(a) of the Fund's Articles of Agreement when undue delays in the availability or use of exchange for current international transactions arise directly from government action. In the context of the use of Fund resources, the objective of eliminating external payments arrears was incorporated into the design of the Fund-supported programs.

payments from residents to non-residents on current international transactions. In addition, the policy initially did not apply to arrears arising from a government default on its own external obligations. Against the background of a growing emergence of sovereign arrears, however, the policy was extended in 1980 to include arrears incurred by governments as a result of default, recognizing their negative impact on a member's credit standing and the effective functioning of the international payment system. As a result, the Fund aligned its position on the elimination of sovereign and jurisdictional arrears, calling for their clearance both in the context of Fund-supported programs and the Fund's surveillance.

8. The Fund introduced in 1989 the policy on lending into sovereign arrears to external private creditors (LIA) as a limited exception to its general policy on non-toleration of arrears. Following debt crises in the early 1980s, financial institutions gradually became increasingly reluctant to provide financing assurances required by the Fund.[7] This unwillingness, which resulted in growing delays in Fund support for adjustment programs, was mainly attributed to the strengthening of banks' balance sheets, the development of second market trading in banks' claims, and the growing recognition that problems faced by many members were those of sustainability rather than liquidity and that a comprehensive resolution of the debt difficulties might entail some debt reduction. As a result of these developments, the Fund's arrears policy had the unintended consequence of giving private creditors an effective veto over Fund support. In 1989, the Fund's arrears policy was modified to allow for approval of a Fund arrangement before arrears to external private creditors had been eliminated.[8] The LIA policy applies to Fund lending into sovereign arrears to external private creditors including bondholders and commercial banks as well as nonsovereign arrears stemming from the imposition of exchange controls.[9, 10]

9. The LIA policy seeks to promote effective adjustment by a member in arrears to external private creditors to secure an orderly debt restructuring aimed at restoring external viability. The policy, which was subsequently modified in light of developments in international capital markets, operates against the backdrop of a Fund arrangement which provides an appropriate balance between financing and adjustment.[11] It gives the member the confidence that the Fund will continue to provide support in the face of difficulties that may emerge in securing the

[7] Upon the receipt of assurances from banks that sufficient financing would be available to eliminate arrears during the arrangement period in a manner consistent with program assumptions (through some combination of news loans to pay interest and rescheduling of principal), the amounts to be rescheduled or refinanced would not be treated as arrears for Fund program purposes or the relevant performance criteria in the arrangement. However, banks generally required that interest falling due pending rescheduling or refinancing be paid on a timely basis.

[8] This modification is not intended to modify the arrears policy vis-à-vis official creditors as the Fund did not experience delays in obtaining the necessary financing assurances from Paris Club creditors.

[9] See *Summing Up by the Acting Chairman on Fund Policy on Arrears to Private Creditors—Further Consideration*.

[10] The LIA policy does not apply to arrears in dispute. Under this practice which arises from the Fund's duty of neutrality, where the Fund accepts a member's representation that the validity or amount of a debt claim is in dispute, such disputed claim does not give rise to arrears for all Fund purposes. However, such claims are taken into account for purposes of determining whether adequate assurances exist for the financing of a Fund-supported program.

[11] The LIA policy applies across all Fund arrangements, including to those under the PRGT (with some flexibility).

agreement of private creditors to provide financing on terms consistent with the program. At the same time, the policy provides creditors with comfort that the financing sought by the debtor is consistent with a burden sharing between financing and adjustment that has been endorsed by the official community.

10. To adequately safeguard Fund resources, the LIA policy establishes clear criteria and conditions for its application. Under the LIA policy, the Fund can lend to a member in arrears on a case-by-case basis and only where (i) prompt Fund support is considered essential for the successful implementation of the member's adjustment program, and (ii) the member is pursuing appropriate policies that is making a good faith effort to reach a collaborative agreement with its private creditors (or to facilitate a collaborative agreement between private debtors and creditors and a good prospect exists for the removal of exchange controls). Where the LIA policy applies, each disbursement under a Fund arrangement is subject to a financing assurances review in which the Board considers, inter alia, whether adequate safeguards remain in place for further use of the Fund's resources, and whether the member's adjustment efforts are undermined by developments in debt-creditor relations.[12]

11. The good faith criterion aims at promoting a collaborative approach to reach a rapid restructuring agreement commanding broad creditor support. This criterion, which was first introduced in 1998, was intended to address concerns about bond restructuring negotiations where the heterogeneity and the increasing size of the creditor base could result in coordination difficulties, delaying the restructuring. It seeks to achieve two primary objectives with respect to debtor-creditor engagement: first to increase the likelihood of achieving broad creditor participation in restructuring deals – which is needed to facilitate normalization of creditor—debtor relations and resumption of market access by the debtor—by providing a mechanism that can help address difficult issue of inter-creditor equity, and second to reduce the adverse spillover effects of individual restructurings on the asset class and thus promote the efficient operation of capital markets more generally by establishing a more predictable process for debt workout.

12. The good faith criterion is assessed against several principles to strike a balance between clarity and flexibility in guiding the dialogue between debtors and their private external creditors.[13] First, a member, after having determining that a restructuring is necessary, should engage in an early dialogue with its creditors until the completion of the restructuring.[14] Second, the member should share relevant, non-confidential information with all creditors on a

[12] See *Summing Up by the Acting Chairman on Fund Policy on Arrears to Private Creditors—Further Consideration*.

[13] For Fund arrangements constituting the track record towards the HIPC Completion Point, the requirement of good faith efforts has been essentially satisfied by the member communicating with, and ultimately offering HIPC terms to, creditors.

[14] The precise form of the dialogue is, however, left to the debtor and its creditors as it needs to be tailored to the circumstances of each individual case. In the context of the 2002 review of the LIA policy, noted that Directors emphasized that flexibility is assessing a good faith effort was needed to accommodate the characteristics of each specific case, to avoid putting debtors at a disadvantage in negotiations with creditors; and to avoid prolonged negotiations that could hamper the ability of the Fund to provide timely financing.

timely basis.[15] Third, the member should provide creditors with an early opportunity to give input on the design of restructuring strategies and the design of individual instruments.[16] The procedural expectations which apply to post-default scenarios vary with the complexity of the case. In cases where an organized negotiating framework is warranted by the complexity of the case and by the fact that creditors have been able to form a representative committee on a timely manner, the debtor member would be expected to enter into good faith negotiations with this committee, though unique characteristics of each case would be considered. In all cases, the modalities guiding the debtor's dialogue with its creditors need to be tailored to the specific features of each individual case. The policy also recognizes that to the extent that negotiations become stalled because creditors are requesting terms that are inconsistent with the adjustment and financing parameters that have been established under a Fund-supported program, the Fund should retain the flexibility to continue to support members notwithstanding the lack of progress in negotiations with creditors. In this regard, the policy notes that it would be inappropriate for private creditors to be given a veto over the design of the financing plan or the adjustment program.[17]

13. The Fund maintains a policy of non-toleration of arrears to official creditors. Fund-supported programs required the elimination of existing arrears and the non-accumulation of new arrears during the program period with respect to official creditors. In practice, arrears to multilateral creditors are considered resolved if the program provides for their clearance.[18] However, with respect to arrears to the World Bank, upfront clearance of the arrears at the beginning of the Fund-supported program or an agreed plan between the member and the World Bank on terms of clearance over a defined period has generally been required in line with the terms of the 1989 Concordat.[19] Staff has sought the views of the World Bank in all cases where the use of Fund resources was requested by a member with arrears to the World Bank. A similar approach has been applied to other multilaterals that are expected to provide substantial financing to the program.[20]

[15] This would normally include (i) an explanation of the economic problems and financial circumstances that justify a debt restructuring, (ii) a briefing on the broad outlines of a viable economic program to address the underlying problems and its implications on the broad financial parameters shaping the envelope of resources available for restructured claims.

[16] See *Fund Policy on Lending Into Arrears to Private Creditors—Further Considerations of the Good Faith Criterion*, and *The Acting Chair's Summing Up on Fund Policy on Lending Into Arrears to Private Creditors—Further Considerations of the Good Faith Criterion*.

[17] *The Acting Chair's Summing Up on Fund Policy on Lending into Arrears to Private Creditors—Further Consideration of the Good Faith Criterion*.

[18] The debtor authorities must have a credible plan and projected financing to eliminate arrears, but concurrence of the creditor on this plan is not required.

[19] *Bank-Fund collaboration in assisting member countries*.

[20] The Fund does not have a clear definition of a multilateral institution or an agreed list of multilateral organization. In practice, the Fund judgment on whether an institution is a multilateral creditor is based on a number of factors including (i) global, rather than regional, membership of the institution; (ii) Paris Club's treatment of claims of the institution, and the institution's participation in the Paris Club; and (iii) the treatment of the institution under the HIPC Initiative.

14. The Fund's practice with respect to arrears to official bilateral creditors has evolved in light of changing circumstances. Because of the well-established rules and practices of the Paris Club and the Fund staff's ongoing contacts with the Paris Club, arrears to Paris Club official bilateral creditors covered by the anticipated terms of the Agreed Minute are deemed eliminated for Fund program purposes when financing assurances are received from the Paris Club prior to the approval of a request for use of Fund resources or completion of a review.[21] Arrears to non-Paris Club bilateral creditors are similarly deemed eliminated for Fund program purposes as the Fund has relied on the Paris Club's comparability of treatment principle and assumed that these creditors will restructure the member's debts on similar terms. In the past, these conventions worked well because Paris Club debt constituted a large share of official bilateral claims. However, since the 1990s, the Paris Club's share of developing countries' debt and financing flows has been steadily declining and new non-Paris Club bilateral creditors are emerging. In cases where there is some official sector concerted action, but falling short of a formal Paris Club Agreed Minute, tacit approval of an official bilateral creditor has been deemed sufficient to satisfy the Fund's arrears policy.[22] Such tacit approval is generally conveyed through non-objection in the Executive Board to the Fund financial support notwithstanding the arrears.

[21] To the extent that arrears are not rescheduled by the deadline set forth in the Agreed Minute, the arrears are considered to arise new for Fund program purposes, unless the Fund considers that the member has exercised its best efforts to concluding the rescheduling agreement.

[22] This approach has been used more commonly in the context of emergency assistance where anticipation has been that such assistance would advance normalization of relations with official bilateral creditors in time for regular treatment in a Fund arrangement. It has also been used in the context of Fund arrangements in a few cases, in the absence of a relevant Paris Club Agreed Minute either because there are no Paris Club creditors involved or the Paris Club share in the arrears is too small.