Carnegie Mellon **Quarterly International Economics Report**
Gailliot Center for Public Policy **April 2002**

SOVEREIGN DEFAULT
THE PRIVATE SECTOR CAN RESOLVE BANKRUPTCY WITHOUT A FORMAL COURT

by
Adam Lerrick and Allan H. Meltzer

The paternalistic era where every financial misstep in every corner of the globe would be righted by an IMF loan is over. After ten sovereign bailouts in seven years mounting to $250 billion, the IMF allowed Argentina to default on some $95 billion of government debt in December 2001. Markets had anticipated the outcome; prices changed little; the contagion to emerging economies near and far simply didn't happen. The arguments for bailouts turned out to be unfounded.

If investment flows are to continue to emerging economies, a new means must be found to bring predictability to the resolution of unsustainable sovereign debt. But will this be imposed by fiat or evolve through market forces? Will the IMF return to its original mandate or extend its command and control over developing nations and markets? Are borrowers and lenders destined to be governed by a ponderous and IMF-sponsored international bankruptcy court? Or can the private sector draw upon time-tried tools to hammer out a new strategy--one that will transform what have historically been disorderly and long drawn-out debt restructuring negotiations? The outcome will determine the wealth and well-being of the globe's developing countries.

Default, after all, is just a form of international bankruptcy declaration. All of the protections of formal proceedings, first developed for domestic bankruptcies, can be built into new debt issues and the old debt can be converted and priced at auction--all in advance of crisis and without a court. Two established capital market tools--exchange offers and exit consent amendments--can be used together to convert the entire outstanding debt in a short period of time.

I. IMF Bankruptcy Court: Resolution by Fiat

In November 2001, Anne Krueger, First Deputy Managing Director of the IMF, proposed a new "international workout mechanism" based on "the model of a domestic bankruptcy court" that would help "countries with unsustainable debts resolve them promptly and in an orderly way". She put the investment community and emerging nations on notice that the choice was no longer "between workout and bailout but between an orderly restructuring and a disorderly one". And she insisted that order could only be found in "statutory" measures, not in the "contractual" agreements that arise naturally in the marketplace to expedite investment.

Amendment of the IMF articles would be needed to create international law that would bind all nations and modify the terms of all financial instruments, even overriding the provisions of existing loans and bonds. The whole would be overseen and enforced by an "independent judicial organ".

Critics came from many quarters--from banks and funds, from economists and legal experts, from emerging nations and finally from the US Treasury. There was one common denominator in the protests: this is an expanded role for the IMF, whether by the institution itself or by the courts and committees it might control behind the scenes. And it is one that will increase--not decrease as claimed--the uncertainty that leads to volatility in markets and will result in less lending at higher costs for emerging economies.

There is fear that the policy objectives of dominant IMF members will influence decisions. There is anticipation of conflict of interest since the IMF and other multilateral agencies are large creditors that may not be forever immune to sharing in losses when debt is restructured. There is hostility to a rigid and static bureaucracy whose decisions are imposed by fiat and are difficult to predict. In sum, we are seeing another episode in the classic confrontation between regulation and free markets.

As the debate continues, the IMF is weakening its rhetoric but not its grip. Much is being made of the free will of debtors and creditors to determine outcomes. Little is being said about the expanded reach that the plan would invest in the IMF or in the allegedly independent courts and committees it would create. The IMF is counting on money, on its ability to grant or withhold massive amounts of desirable subsidized funding, to force debtors and creditors to comply with Fund wishes at every stage of the restructuring process.

Whether directly or indirectly, the IMF would be empowered to:

- Decide how long creditors can be prevented from suing a defaulted borrower.
- Rule on whether a nation's economic policies are sound and whether it is negotiating in good faith.
- Control access to interim financing while existing debt payments are suspended.
- Hold a veto over restructuring agreements reached by the debtor and its creditors.

II. A Market-Based Solution: Private Sector Tools

Markets survive on an ability to evolve and adapt. Now a whole new set of incentives prevails. When the easy fix of bailouts was an option, both borrowers and lenders were wise to pile up obstacles in the path of restructuring to force a stream of subsidized funds from the industrialized world that made good capital market losses and glossed over country policy errors. With bailouts ruled out, the private sector is confronted with a choice: accept regulation or find its own solution to make restructuring work.

For over a century, financial contract law has sought to contain what Francis Palmer, the English jurist, called "the tyranny of the minority". Many bonds now require 100% agreement to reduce borrower debt burdens. Renegade investors, who seek to hold the restructuring process hostage and enrich themselves at the expense of the body of well-meaning bondholders, still remain the stumbling block in an orderly resolution of debt claims.

Incorporate Majority Action Clauses: A Discipline by Peers

When Under Secretary of Treasury John Taylor opted for "a decentralized and market-oriented approach" in testimony before the Joint Economic Committee of Congress in February, he proposed a simple answer: a package of protective clauses would be simply built into all sovereign bonds going forward, as has been the practice under United Kingdom law for the past century.

Majority action clauses by which a super-majority of creditors can impose an amendment to the payment terms of debt instruments on a dissenting minority can resolve the difficulties posed by holdout investors. To be truly effective, these clauses should not be applied issue by issue but across all debt of the same priority rank. Otherwise, a maverick investor, who accumulates a blocking minority position in a single small issue, can attempt to hold hostage the entire restructuring process. The voting provision should be based upon a super-majority of all creditors of the same priority, regardless of the instrument held--bond, loan or trade credit--as long as the treatment of all individual groups of claims is non-discriminatory.

Replicate the Protections of a Domestic Bankruptcy Court

All of the protections provided by an elaborate sovereign bankruptcy court can be easily replicated in debt contracts. Automatic stay of individual creditor litigation through the use of a trust indenture where the trustee controls all action against the debtor on behalf of all bondholders; targeted subordination of outstanding claims to interim lenders, the equivalent of Debtor-In-Possession financing, to continue debt service in a liquidity crisis; and other desired elements can be integrated into the new bonds. Again, voting should be across all creditors of the same rank regardless of instrument held. All other debt instruments, such as bank loans and trade credits, would be amended to match the new bond provisions.

Convert the Outstanding Stock of Debt

The outstanding stock of old debt remains vulnerable to predators. Complex in its variety of issues, distributed among many investors and lacking the protective provisions, this is now the chief argument for an official bankruptcy court. It is claimed that without a formal procedure, an orderly framework for debt restructuring must await the maturity of all bonds--as long as 30 years. In fact, this can be accomplished in a short period of time.

The exchange offer, where a borrower offers investors the option to swap securities they hold for replacement instruments, is one of the classic tools of the capital markets. Long before crisis comes, sovereign borrowers can transform their debt by offering to exchange old bonds for new with a single difference--the majority action provisions that will match the protection in future issues.

The exchange would be voluntary and, when executed through a series of auctions, the market would set a price that reflects the collective view of the value of the new safety measures. The stronger the IMF “no bailout” policy, the lower will be the price. Borrowers would accept or refuse investor offers at each round and a set of rules could ensure that a mutually agreeable clearing price rapidly emerges. Because bondholders benefit, costs to borrowers would be minimal and offset by better terms for borrowing in the more predictable environment that follows.

Exit consent amendments, another corporate finance technique, would induce participation in the offer. As the exchange takes place, bondholders would approve amendments to the non-payment terms of the old instruments they have traded, destroying the value of any stockpile hoarded by holdouts. Once the requisite majority of a bond issue has accepted the amendments (51% or 67% depending upon the issue), they would be binding upon any remaining holders. Exit consents allowed Ecuador to achieve 99% participation in its debt exchange in 2000.

In contrast to exchanges after default has occurred, vulture investors would not be attracted to the old bonds because there is no profit in disrupting the exchange. Nothing can be gained from keeping amended old bonds, for investors would simply be left with a claim that has reduced protection and liquidity. Since no event of default would have occurred, there would be no ability to sue and extract preferential treatment. Stockpiling old bonds today on the chance that, at some distant uncertain date, a payment default will occur and a nuisance value will materialize is not a profitable strategy.

Investors can be Accessed

Reaching the broad spectrum of investors is not as difficult as proponents of the bankruptcy court claim. In 2001, Argentina successfully exchanged approximately 1/3 of its debt (1/2 of eligible bonds) through voluntary operations without the use of exit consent amendments. The Mortgage Bank of Argentina has reached agreement with more than 90% of its European retail investors in its current debt exchange. Mechanisms could be provided to allow investors to continue to exchange old bonds at lower exchange values after the expiration of the offer.

Incentives to Convert

It will be argued that debtors in sound financial condition have no motivation to embrace change where costs are incurred upfront and benefits seem remote, perhaps at a time when another Minister of Finance is in office. But there are immediate benefits. Converted instruments would trade at narrower spreads in the market reflecting the predictability of an orderly restructuring if crisis should occur. Lower costs of financing on new borrowing and greater access to funds would result. The weaker the credit, the greater the immediate gain.

After a small group of countries initiates the process and gains a relative advantage in financing, the rest would follow. If many borrowers execute conversions in unison, no stigma of imminent trouble can be attached to the reform and markets would not penalize the debtor's cost of funds.

Debtors can be encouraged by the IMF to convert their existing bonds by making the new provisions a precondition for access to official financing. The "no bailout" policy should be firmly reiterated to underscore that subsidized official intervention is no longer forthcoming. The IMF should also consider subsidizing the cost of conversion for debtors as a global public good. Financing could be generated through adjustments to the Fund's rate of remuneration on credit balances and rate of charge on loans as has been done in the past for special programs.

III. Conclusion

A market-based solution can convert potential chaos to a framework that permits the orderly restructuring of sovereign debt. Predators would be circumvented and a more certain environment for long-term investment would prevail. The market would set the price of reform through voluntary exchanges; and, if investors are convinced that reform is beneficial, changeover costs would be minimal. Capital flows to emerging markets would be encouraged and costs to borrowers diminished.

Whether the market would place a fair price on the peace of mind these exchanges offer is hard to foretell. Once the private sector internalizes what is effectively a G7 edict for change, markets will adapt. The cost of a self-determined solution will be far less than the price set by the uncertainty and inefficiency that a formal court will impose.