SOVEREIGN DEBT RENEGOTIATION: RESTRUCTURING THE COMMERCIAL DEBT OF HIPC DEBTOR COUNTRIES

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I

INTRODUCTION

In 1996, the International Monetary Fund (IMF) and the World Bank launched the Heavily Indebted Poor Countries (HIPC) Debt Relief Initiative. The HIPC Initiative created a framework for all creditors, including multilateral creditors, to provide debt relief to the world's poorest and most heavily indebted countries, thereby reducing the constraints on economic growth and poverty reduction imposed by the debt build-up in these countries. This initiative marked a big step forward from the previous approach to over-indebtedness of developing countries, which had been limited to temporary postponements of debt-service payments.[1] The HIPC Initiative was modified in 1999 by key enhancements designed to provide more efficient debt relief through a stronger link between debt-reduction and poverty-reduction strategies. Under the HIPC Initiative, the IMF and the World Bank boards first determine (at the "decision point") whether a country is eligible for debt relief. If an affirmative decision is reached, all creditors (multilateral, bilateral, and commercial) are requested[2] to commit to provide debt relief once the country has satisfactorily carried out certain prescribed policy reforms (the "completion point"). The criterion for debt sustainability and the measure of the requested debt relief are based on a comparison of the net present value of the country's external debt to its exports (or in certain cases, fiscal revenues). The objective is to reduce the country's external debt to not more than 150% of exports (or, in

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1. COUMBA FALL GUEYE ET AL., NEGOTIATING DEBT REDUCTION IN THE HIPC INITIATIVE AND BEYOND 1 (2007).

2. In the absence of a mandatory bankruptcy framework for sovereign debtors, HIPC debt relief is provided on a voluntary basis and depends on the commercial assessment, if not the goodwill, of each participating creditor of the HIPC debtor.

certain cases, 250% of fiscal revenues), which is deemed a sustainable level of debt.[3]

Depending on the level of a country's commercial debt, participation of commercial creditors in the HIPC Initiative may be a significant factor in achieving the HIPC debt-relief objective.[4] As legal counsel to certain latecomers to the HIPC Initiative, we have dealt with the challenges of applying the burden-sharing principle underlying the HIPC Initiative to commercial creditors. This article examines salient issues relating to the restructuring of external indebtedness owed to private creditors of HIPC countries, focusing in particular on the debt-relief mechanisms incorporated in the HIPC Initiative as implemented by the IMF, the World Bank, and the Paris Club.[5] Our purpose is to analyze certain inherent contradictions between the IMF and World Bank-driven debt-restructuring scheme and a truly market-driven debt-restructuring of the kind expected by private lenders. The shortcomings of the debt-sustainability analysis underpinning the HIPC Initiative may help explain why a number of commercial creditors of HIPC debtors have resorted to litigation to collect on their claims rather than participate alongside official and other creditors in the HIPC Initiative, thus raising significant challenges to one of the fundamental principles of the HIPC Initiative: burden-sharing among creditors.[6]

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3. For more details on the HIPC Initiative, see INT'L MONETARY FUND, ANNUAL REPORT OF THE EXECUTIVE BOARD FOR THE FINANCIAL YEAR ENDED APRIL 30, 1999, at 83–90 (1999) [hereinafter IMF 1999] (discussing the Executive Board's analysis of the Enhanced Structural Adjustment Facility—providing concessional loans for low-income member countries—and the HIPC Initiative seeking to improve the effectiveness of both initiatives in aiding poor developing countries achieve growth, external debt viability, and poverty reduction); INT'L MONETARY FUND, ANNUAL REPORT OF THE EXECUTIVE BOARD FOR THE FINANCIAL YEAR ENDED APRIL 30, 2000, at 49–61 (2000) [hereinafter IMF 2000].

4. *See* GUEYE, *supra* note 1, at 57. Commercial debt represented between thirteen percent and thirty-five percent of the total external debt of countries such as the Republic of Congo, Côte d'Ivoire, Liberia, and Sudan. Depending on the composition of its external debt, low commercial-creditor participation could prevent an HIPC debtor from getting relief from the IMF, which requires creditors holding seventy percent of eligible debt to participate at the decision point, and eighty percent at the completion point. *Id*.

5. The Paris Club is a forum of official creditors organized under the auspices of the French Treasury that convenes to renegotiate bilateral export credits extended or guaranteed by official creditors. *See generally* PARIS CLUB, http://www.clubdeparis.org (last visited Mar. 18, 2010). It is currently comprised of nineteen permanent members and has met regularly in Paris since 1956 to reschedule bilateral debts. *Id.* Paris Club creditors meet with a debtor country to agree on common terms to reschedule its bilateral export credits as part of the international support provided to a country experiencing debt-servicing difficulties and pursuing an economic program supported by the IMF. *Id.*

6. *See* INT'L MONETARY FUND, ANNUAL REPORT OF THE EXECUTIVE BOARD FOR THE FINANCIAL YEAR ENDED APRIL 30, 1997, at 121 (1997) [hereinafter IMF 1997].

II

BURDEN-SHARING BETWEEN OFFICIAL AND COMMERCIAL CREDITORS

Under the concept of burden-sharing, all creditors of a HIPC debtor country are expected to provide debt relief in proportion to their share of the net present value of debt outstanding at the time of the decision point.[7] This principle contemplates the comparable treatment of different classes of creditors by application of a burden-sharing formula (the "common reduction factor") to the net present value of each class of creditors' debt stock.[8] In practice, the IMF and the World Bank determine an acceptable level of indebtedness (using the 150% or the 250% target level), compare that amount to the net present value of the debt outstanding on a predetermined measurement date, and apportion the required reduction among the official and commercial creditors based on the common reduction factor.[9] If a creditor class has granted debt-stock relief after the measurement date, that relief is automatically taken into account in calculating the further relief needed to comply with the requested HIPC debt-relief effort, since relief is measured by comparing the new debt levels with the levels prevailing on the measurement date.

On its face, the use of a neutral mechanism to ensure comparable treatment of different classes of creditors seems not only fair, but also efficient, for it should in principle eliminate a major stumbling block to negotiations with different creditor groups. In the case of official creditors such as the IMF, the World Bank, the other multilateral institutions, and the bilateral official creditors, this approach seems to work reasonably well. For various political and other reasons, official creditors have a common interest and a common objective in supporting the efforts of sovereign borrowers to reduce poverty and achieve sustainable growth, at least for those borrowers that follow sound policies.[10] They view themselves as long-term partners of their borrowers and do

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7. INT'L MONETARY FUND, EXTERNAL DEBT STATISTICS, GUIDE FOR COMPILERS AND USERS 265, 288–90 (2003) [hereinafter IMF 2003]. This rule is supplemented by the "comparability of treatment" clause contained in agreements with the Paris Club, which often represents the largest creditor bloc of an HIPC debtor. *What Does Comparability of Treatment Mean?*, PARIS CLUB, http://www.clubdeparis.org/sections/composition/principes/comparabilite-traitement/switchLanguage/en (last visited Mar. 18, 2010). In accordance with this clause, the debtor country seeks treatment "comparable" to the Paris Club's agreement from nonmultilateral and private creditors, in particular, other bilateral creditors that are not members of the Paris Club. *Id.*

8. *See* INT'L MONETARY FUND, DEBT RELIEF FOR THE POOREST COUNTRIES: MILESTONE ACHIEVED, JOINT STATEMENT BY HORST KÖHLER AND JAMES D. WOLFENSOHN, Chart A, Note (2000), www.imf.org/external/np/hipc/2000/state/state.pdf (last visited Aug. 4, 2010).

9. *See* IMF 2003, *supra* note 7, at 288; *see also, e.g.*, INT'L MONETARY FUND, CÔTE D'IVOIRE: ENHANCED HEAVILY INDEBTED POOR COUNTRIES (HICP) INITIATIVE: PRELIMINARY DOCUMENT 18 (2009) [hereinafter IMF 2009] (applying the 250% target level to Côte d'Ivoire's external debt).

10. For the vision of international cooperation and mutual assistance among member countries that underlies the IMF, *see, e.g.*, the purposes of the IMF as outlined in Article I of its Articles of Agreement.

not dispose of their debt. As a consequence, treating all official creditors the same way after taking account of any prior debt relief which they may have granted makes sense as it is both fair and consistent with the policy values of official lending. From the debtor's point of view, any mechanism for the allocation of debt relief that is acceptable to the creditors should be acceptable to the sovereign debtor as long as the ensuing aggregate external debt and debt-service requirements do not exceed sustainable levels. The question is, does the HIPC approach for allocating debt relief among official creditors make sense when applied to commercial creditors.

In the case of commercial creditors, it is fair to ask two fundamental questions: First, in the context of HIPC sanctioned debt relief, are past debt relief and the notion of "credit" for past debt relief appropriate factors to take into account in restructuring debt owed to them? Second, does the concept of equitable treatment of creditors require that claims of commercial creditors be reduced in the same way as the claims of official creditors, as suggested by the HIPC Initiative?[11] As to the first question, commercial creditors do not lend to provide policy support to sovereign borrowers. They are commercial actors whose debt claims, whether in the form of bank loans or sovereign bonds, are generally freely assignable and their business does not require them to hold sovereign debt to maturity. On the contrary, they make a decision every day whether or not to hold or sell loans. Moreover, the universe of creditors of any HIPC country today is unlikely to include more than a handful (if any) of the creditors that originally extended credit directly to the borrower. Most creditors will have purchased debt in the secondary market, often at substantial discounts to face value. Indeed, the commercial debt claims against HIPC countries often date back to over twenty years ago.[12] If the private external debt of the borrower was previously restructured, some existing creditors may have participated in the restructuring, but most will not have. Commercial creditors do not analyze their position vis-à-vis other commercial creditors based on what they paid for their debt or what impairment they may previously have accepted.

Second, whereas it may make sense for official creditors to acknowledge and account for past uncoordinated debt-relief efforts by each of them in determining how to allocate equitably future debt relief, there is no market-based logic in extending this approach to commercial creditors, even when those creditors were original lenders to the HIPC debtor country. Established

11. *See, e.g.*, IMF 2009, *supra* note 9, at 17 (2009) ("Arrears to bilateral and commercial creditors will need to be regularized in the context of discussions on HIPC debt relief and rescheduling with those creditors. Any relief already granted by those creditors beyond traditional debt relief mechanisms will be credited towards their share in HIPC relief. Côte d'Ivoire has held preliminary discussions with both Paris Club and London Club creditors on debt relief and rescheduling.").

12. In the case of Côte d'Ivoire, in which we were involved, the commercial debt claims subject to HIPC treatment dated back to the 1980s and were securitized in connection with the country's Brady plan transaction in 1998. The country closed the restructuring of its Brady bonds in April 2010. Similarly, the commercial debt claims of the Republic of Congo, which were restructured in December 2007, dated back to the 1980s.

practice in private debt markets requires that all claims of unsecured private creditors be treated equally, whether the creditors were original lenders who paid 100 cents on the dollar for their debt and granted debt relief in the past, or institutions that purchased their debt on the secondary market, long after default, for a small fraction of its nominal value.[13] In fact, outside the realm of the HIPC Initiative, whether one looks at private-sector borrowers or sovereign borrowers, there is no precedent for granting different treatment to different creditors based on when they acquired their debt, on how much they paid for it, or on whether they previously suffered a loss through the grant of debt relief. The notion of credit for past debt relief—a critical element in applying the burden-sharing principle to official creditors—does not accord with how commercial creditors value or trade their claims, or comport with market practice. In practice, in the absence of official debt, commercial creditors do not restructure debt by mechanically crediting past debt relief and then applying a common reduction factor. In our experience, the parties generally negotiate a restructuring plan that reflects the country's prospects and that promises some reasonable assurance that the debtor country will honor its terms. Moreover, the claims of all unsecured creditors are invariably treated identically, irrespective of past debt relief or the cost of the claims to the creditors.

III

DEBT SUSTAINABILITY AND CAPACITY TO PAY

Aside from the concept of burden-sharing, another key feature of the HIPC Initiative is that debt relief should be based on a formulaic notion of debt sustainability. Determining the debt relief a country requires as a function of the level of debt it can service on a sustainable basis makes obvious sense, and the comprehensive approach to debt relief by different classes of creditors introduced with the HIPC Initiative in 1996 marked an important advance.[14] This change was made possible by the decisive involvement of the IMF and the World Bank as actual stakeholders in the debt-relief process.[15] Thanks to their privileged access to the economic and financial information of poor debtor countries,[16] the Bretton Woods Institutions[17] are in a position to base the debt-

13. The London Club steering committees established by the latecomers to the HIPC Initiative have generally been comprised of original lenders (traditional banks) and some more recent actors in the sovereign debt area (for example, hedge funds). It appears that no one has ever suggested treating the claims of these two groups of creditors differently.

14. *See* GUEYE, *supra* note 1, at 1–3; *see also* IMF 1999, *supra* note 3, at 83; IMF 2000, *supra* note 3, at 50.

15. Until 1996, the debt-relief process did not include debts owed to multilateral institutions such as the IMF, the World Bank, and other international organizations. This was increasingly a problem for poor indebted countries, and an impediment to obtaining debt relief from commercial creditors, who saw themselves as unfairly disfavored.

16. Pursuant to Article VIII, Section 5 of the Articles of Agreement of the IMF, the member countries must furnish to the IMF such information as it deems necessary for its activities. The Articles

relief process (and the computation of their own share of the total debt relief) on a debt-sustainability analysis conducted jointly with the authorities of the debtor country.

However, to determine debt sustainability, the HIPC Initiative relies on a criterion (the ratio of the net present value of debt stock to exports or fiscal revenues) that is both simplistic and imperfect. It differs markedly from the approach embodied in negotiated workouts of debt owed by public- or private-sector borrowers to private financial institutions. Unlike the analysis that any well-advised commercial creditor (or debtor, for that matter) would undertake, the HIPC debt-sustainability formula is an incomplete and static measure that does not accurately measure the ability of a debtor to service its restructured debt.

First, the HIPC debt-sustainability test ignores domestic debt, so it does not take into account the debt-payment obligations of the HIPC country vis-à-vis its domestic creditors, even though a high level of domestic debt increases the likelihood of external-debt distress. Restoring external-debt sustainability does not necessarily achieve fiscal sustainability of total public debt; indeed, "[t]he latter would target the [present value] ratio of *total public (domestic and external) debt* in relation to appropriately adjusted domestic budget revenues."[18] The exclusion of domestic debt from the HIPC debt-sustainability calculus is also problematic from the standpoint of the commercial creditors. Two essential principles of private sector insolvency workouts are that the level of debt relief sought by the debtor should be based on a true and full picture of the debtor's payment capacity, and that no class of creditors should be arbitrarily favored.[19]

Second, because the debt-sustainability analysis used in the HIPC program is frequently based on data that is stale at the time of the negotiations with commercial creditors,[20] the common reduction factor calculated for the HIPC debtor country may ignore facts that are germane to the relief being sought and that may figure prominently in negotiations with private creditors. Thus, a debtor may invoke the common reduction factor agreed upon by the multilateral and bilateral creditors to obtain more relief than its actual situation warrants (for example, because of a dramatic shift in its terms of trade after the

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of Agreement of the International Monetary Fund were adopted at the United Nations Monetary and Financial Conference in Bretton Woods, New Hampshire, on July 22, 1944.

17. *See About the Bretton Woods Committee*, THE BRETTON WOODS COMMITTEE, http://www.brettonwoods.org/index.php/167/About_the_Bretton_Woods_Committee (last visited Mar. 18, 2010) (noting that the World Bank, IMF, WTO, and regional development banks are known as the "Bretton Woods Institutions").

18. *See* Mothae Maruping, *Lessons from Eastern and Southern Africa*, *in* HIPC DEBT RELIEF: MYTHS AND REALITY 57, 65 (Jan Joost Teunissen & Age Akkerman eds., 2004) (emphasis added).

19. There is an argument, however, that in the case of domestic debt denominated in a country's own currency, where it has the ability to print money and control the money supply, domestic debt deserves different treatment from debt denominated in scarce foreign currency, the supply of which is finite.

20. In our experience, the time often exceeds one year.

measurement date).[21] Likewise, creditors may invoke the common reduction factor to justify a rejection of demands for much-needed relief (for example, because exogenous events arising after the measurement date have significantly reduced the debtor's foreign currency revenues).[22]

Third, the HIPC test of debt sustainability ignores year-by-year cash-flow constraints in that it looks solely to the net present value of debt stock. A debtor's cash requirements and availability are critical to determining its ability to meet debt-service requirements. Yet, oddly, the HIPC measure of debt sustainability ignores this fundamental element of fiscal soundness. Perversely, this approach allows creditors who place a greater premium on rapid repayment than on full repayment (because, for example, they regard the risk of renewed default beyond the short to medium term as unacceptably high) to insist on payment terms that meet the net-present-value test but place a significant burden on the debtor country's cash flow when it can least afford it.

From both the debtor's and commercial creditors' points of view, the HIPC debt-sustainability test fails, therefore, to provide a satisfactory measure of a HIPC country's capacity to pay. A sovereign borrower's capacity to pay is a much more subtle and inexact measure than a ratio of net present value of debt stock to exports or fiscal revenues. Moreover, in the case of a sovereign borrower, the concept of capacity to pay is not just economic, but political as well. The ability to pay is meaningless without the political willingness to pay. Political and social realities may place limits on the amount of resources that a country will, or as a practical matter can, dedicate to servicing its external debt as opposed to making other social and economic expenditures. Thus, negotiations between the HIPC debtor and commercial creditors focus on balancing the creditors' desire for maximum recovery with the debtor's desire to marshal sufficient resources to fund a program of recovery, poverty reduction, and sustainable growth. (The costs of such programs vary widely from country to country and are not considered in the HIPC debt-sustainability analysis.) These negotiations cannot rely on a mechanical application of the HIPC burden-sharing formula and debt-sustainability test. Rather, they tend to be lengthier and more difficult because commercial creditors are less likely than official creditors to forgive debt merely to protect geopolitical interests or to solidify future relationships with the sovereign debtor.[23]

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21. This was the case of the Republic of Congo, whose financial situation had considerably improved between its decision point and the time of the negotiations with its commercial creditors due to a steep increase in the price of oil, its key export.

22. In the case of Côte d'Ivoire, the evolution of the domestic political situation had significantly impaired its payment capacity compared to what was suggested by the debt-sustainability analysis.

23. The composition of the pool of commercial creditors is also sometimes a source of difficulty and delays. Today, the holders of the commercial debt of HIPC countries typically include a small, core group of bank creditors with continuing commercial relationships in the debtor country (such as trade finance, short-term lines for special purposes, hedging operations, and ties to the private sector), as well as hedge funds and debt traders that acquired their claims on the secondary market and have no particular investment in the country's future other than the market price of their debt. The perspectives and the short-term- and long-term interests of these groups may differ considerably. Notwithstanding

IV

CONCLUSION

The IMF and the World Bank could make another important contribution to the rehabilitation of HIPC countries by helping them develop the data- and debt-management policies and human resources to better assess their capacity to pay. There is no better incentive for creditors to participate in a debt restructuring than the confidence that the basic deal is fair and that the borrower has both made a commitment and demonstrated that it believes it to be in its own interest to implement sound policies. Under these circumstances, linking the restructuring of private and official debt can provide added value to all parties: assurance of comparability of treatment, reason to believe that the debtor will be able to perform, and the ability of the multilateral institutions to couple debt relief with conditionality designed to foster sound policies.

this divergence of interests, creditors often manifest a strong preference to fix the terms of a debt restructuring through negotiation with an ad hoc committee of creditors. Faced with a committee of creditors with different interests, a sovereign borrower is likely to find itself on the receiving end of proposals that reflect the "lowest common denominator" among the positions of the creditors. Experience has shown that this conflict of interest within private-lender committees may hamper the progress of sovereign debt negotiations.