November 25, 2013

The Role of the IMF in Future Sovereign Debt Restructurings

Report of the Annenberg House Expert Group

A one-day meeting of international finance and insolvency experts was held on November 2, 2013 at the Annenberg House in Santa Monica, California. The meeting was co-hosted by the University of Southern California Gould School of Law and the Annenberg Retreat at Sunnylands. The participants at the meeting are listed in Attachment A to this Report.

The topic of the meeting was "The Role of the IMF in Future Sovereign Debt Restructurings." An agenda (copy attached as Attachment B) was circulated to the participants prior to the meeting.

The goal of the meeting was to solicit the views of a diverse group of experts on the practical implications of the IMF's April 26, 2013 paper captioned "Sovereign Debt Restructuring -- Recent Developments and Implications for the Fund's Legal and Policy Framework" (the "April 26 Paper"). The April 26 Paper may signal a major shift in IMF policies in the area of sovereign debt workouts. A number of the proposals in the April 26 Paper are likely to be controversial and the IMF Executive Board has instructed the Fund staff to prepare more detailed analyses of these issues. The University of Southern California Gould School of Law invited the participants in the Expert Group to provide an independent assessment of the desirability and feasibility of some of the key recommendations in the April 26 Paper.*

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* Participants provided their views strictly in their personal capacities and not as representatives of their respective institutions.

The Paragraph 32 Proposals

Although the Expert Group discussed a number of the ideas contained in the April 26 Paper, attention focused in particular on paragraph 32 of that paper. This paragraph reads as follows:

> 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. 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.

This Report will summarize the consensus views[1] of the Expert Group on the practical implications of the suggestions contained in paragraph 32 of the April 26 Paper.

Background

Debtor countries normally approach the IMF for financial assistance only when they have lost market access and exhausted other means of financing. By the time the Fund is consulted, the private capital markets will have reached a collective judgment that someone -- perhaps everyone -- is at risk of losing money in the debtor country (let us call that country "Debtorania"). Markets can, of course, be wrong in these judgments. Investors may turn skittish for a number of reasons that are unrelated to the economic fundamentals of Debtorania. These may include a reaction to the misbehavior or misfortune of a sovereign debtor elsewhere in the world, adversity in the global financial picture generally, a significant shift in interest rates, a currency crisis, an unexpected (and alarming) political development in Debtorania or elsewhere, and so forth.

Skittish markets can be characterized by a herd mentality; individual investors exiting primarily because they see other investors exiting. Herds are no doubt occasionally spooked needlessly, but there must also be times when the herd -- or the more discerning members of the herd -- have sensed the presence of a pride of lions in the tall grass. It may be difficult for the IMF to know in every case whether Debtorania's loss of private market access is the result of baseless alarms or whether the market may have correctly diagnosed a serious problem with the sustainability of Debtorania's stock of debt.

Fund programs that involve advancing the full amount needed to cover anticipated budget deficits and to repay, in full and on time, all items of debt maturing during the program period effectively prejudge the outcome of this question.[2] Should Debtorania's problems indeed prove to be structural and chronic (and the loss of market access certainly raises a fair suspicion in this regard), any new official sector loans that repay private sector creditors at par only shift the risk of an eventual debt restructuring onto the shoulders of the official sector.

There are only three tactical options for the Fund at the outset of an adjustment program where the medium term debt sustainability of the member country is in doubt:

[1] Opinions of individual members of the Expert Group on certain issues sometimes differed.

[2] With the sole exception of the belated debt restructuring in Greece in 2012, this has been the model used in the Eurozone debt crisis that began in early 2010.

1. Lend the country the amount needed to repay in full all obligations maturing during the program period (a "Full Bailout"),

2. Require a full restructuring (affecting principal/interest and maturity) of the country's debt at the outset of the program in order to remove any doubt about the sustainability of that debt stock (a "Pre-emptive Restructuring"), or

3. Require a milder form of restructuring that pushes maturities out of the program period without imposing principal or interest rate haircuts (a "Reprofiling").

Option 1 shifts the risk of an eventual debt restructuring onto the official sector and allows the original creditors to escape unscathed. Option 2 may force a sovereign debtor into a painful and unnecessary debt restructuring, bruising the debtor's reputation in the capital markets for years to come. That leaves Option 3, a Reprofiling -- a temporizing measure to be sure but one that preserves the status quo until a more informed judgment can be made about the likely depth and duration of the country's problems.

The Reprofiling Option

The Expert Group broadly agrees with the suggestion in paragraph 32 of the April 26 Paper that in certain situations Fund programs should presume the need for a stretch out of maturing debt to remove those liabilities from the program period. This presumption, however, should be rebuttable. In cases where the Fund staff is confident that the debtor country is experiencing only a temporary liquidity problem, an adjustment to the repayment profile will not be necessary and should not be undertaken. The Expert Group discussed the advisability of also recognizing an exception for unusual circumstances (such as a clear and present danger of regional contagion), but decided that the IMF would frequently be pressured to avoid or defer a needed Reprofiling on the grounds of "unusual circumstances". There will always be interested parties who will argue that the path of least resistance and risk is a full bailout and the Fund's record of resisting pressure from its larger shareholders in areas where the Fund has discretion is not encouraging. The consensus of the Expert Group was therefore not to recommend an "unusual circumstances" exemption from the presumptive need for a Reprofiling.

The consensus of the Expert Group was that a Reprofiling should normally affect all outstanding bonds of the debtor country, even those maturing after the program is scheduled to end. Imposing the discomfort of the Reprofiling only on the sovereign's short-dated paper would be inconsistent with the goal of intercreditor equity. Moreover, unless the entire curve is pushed out evenly, the reprofiled bonds could, on their new terms, mature at the same time as some of the untouched instruments, possibly producing an unhealthy spike in the debt profile in the first few years after the program ends.

As for the length of the Reprofiling stretch out, the Expert Group felt this would normally be 3-5 years but should reflect the Fund's assessment of the period required for the fiscal adjustment measures to restore the country to perceived creditworthiness. The stretching out of maturities for 3-5 years will allow the Fund to assess the situation and the country's progress toward economic adjustment. If it turns out that the situation deteriorates or the Fund's initial projections are shown to have been too optimistic, preparations can then be made to implement a more severe form of debt restructuring.

The objectives of a presumptive need for Reprofiling the debt stock of a member country that has lost market access are:

1. <u>Reduce the call on Fund resources</u>. First and foremost, a Reprofiling obviates the need for the Fund to advance money that immediately bleeds out to repay existing creditors at par. In most cases, this will significantly reduce the size of the official sector rescue package.

2. <u>Allow time for diagnosis</u>. A Reprofiling will take Debtorania out of the market for the period of the stretch out. This will give the Fund time to assess the depth of the problem and the likelihood that the fiscal adjustment measures will succeed in restoring the country to a sustainable position.

3. <u>Allow time for adjustment measures to take hold</u>. Because Debtorania will not again have to face market scrutiny until the stretch out period ends, the country's fiscal adjustment measures will have time to take hold and show the results that the market would expect to see before lending is resumed.

4. <u>Lock in the private sector</u>. While Debtorania's bonds will continue to trade in the market during the Reprofiling period, the important point is that they will remain in the hands of private sector investors. In the event that adjustment efforts fail and a deeper restructuring becomes necessary, the restructuring

burden will be shared equally by all private sector creditors. A migration of the liabilities from the private sector to the official sector of the kind we have seen in the Eurozone periphery will thus be avoided.

6. Allow time to hedge. An institutional investor that felt itself overexposed to Debtorania and did not wish to risk the possibility of a full blown restructuring after the Reprofiling period ends, can use the period of the stretch out to sell or hedge its position in an orderly manner.

7. Debtor country incentives. Everyone will know that a failure to regain market access when the stretch out period ends may force a more severe debt restructuring at that point. This knowledge should create an additional incentive for Debtorania to stick with its fiscal adjustment program.

Risk and Risk Mitigants

1. Collateral damage. All sovereign debt restructurings, even mild ones, exact a cost. That cost will take the form of a bruised credit reputation for some period of time, deferred reaccess to voluntary markets, higher borrowing costs for both the sovereign and its local corporate issuers and so forth. Putting moral hazard concerns aside, if the eventual costs of a Reprofiling could be calibrated and balanced against the eventual costs of the other two options -- a Full Bailout or a Pre-emptive Restructuring -- a completely enlightened decision maker would be able to choose the optimal path, at least in a utilitarian sense. But that will never happen. The counterfactual is never a matter of proof, only speculation.

   That said, empirical studies suggest that milder forms of debt restructuring which do not involve outright principal haircuts are forgotten and forgiven by the markets more rapidly.[3] The reason? Like true love, a principal haircut is forever. But a simple deferral of principal repayment allows the creditor to benefit from the uptick in market value of the paper if and when the sovereign's fortunes begin to improve. The classic

[3] *See* Juan J. Cruces & Christoph Trebesch, *Sovereign Defaults: The Price of Haircuts*, 85 AM. ECON. J. 85 (2013).

example of a sovereign debt reprofiling -- Uruguay in 2003 -- was followed by a new, entirely voluntary, bond issue by Uruguay just 31 days after the reprofiling of the country's existing bonds closed in May of that year.

2. Self-fulfilling runs. The second major concern is that the market, faced with the high likelihood of a mandatory maturity extension at the outset of a Fund-prescribed adjustment program, could dump the country's bonds prematurely.

   The consensus of the Expert Group was that this risk could be managed by designing the policy in such a way as to treat loss of market access as a necessary but not sufficient condition for Reprofiling. Reprofiling would occur only in situations in which the fundamentals of the country -- debt levels, primary deficits, and other variables that do not react to market panics -- indicate that the country's debt may well be unsustainable. This rules out a vicious circle between expectations of reprofiling and actual reprofiling.

   This is not to say that the presence of a reprofiling policy may not lead to an earlier loss of market access. Indeed, the express purpose of the policy is to discourage private sector lending to countries with doubtful debt sustainability on the assumption that the official sector will be there to bail them out completely. Provided that the criteria for reprofiling are defined sufficiently conservatively, earlier loss of market access could actually be a desirable consequence of the policy. Mistakes will no doubt occasionally be made, in both directions -- both unnecessary reprofiling of debts, and failing to reprofile debts when this would have been appropriate. But this is preferable to the current situation, in which mistakes tend to all go in the same direction and debt restructurings tend to occur too late, forcing far larger costs on the country and far greater losses on the remaining creditors.

Holdouts

The word "reprofiling" is deliberately euphonious. In truth, a Reprofiling is one species under the broader genus "restructuring". And a debt restructuring is just a polite way of saying that the obligations will not be performed according to their original terms, which is itself merely a delicate way of describing a default.

The sentiment expressed in the penultimate sentence of paragraph 32 of the April 26 paper (to the effect that Reprofilings will be "voluntary" and supported by creditors out of enlightened self-interest) is, in the consensus view of the Expert Group, optimistic. Telling a member country that it will be expected to Reprofile its debt as a condition to IMF support is tantamount to telling the country that it must default on that debt. It is fatuous to believe that all creditors will voluntarily accept even a mild stretch out of their claims. There will be holdouts.[4] The IMF has been notoriously timid in confronting this disagreeable fact of financial life, often hiding behind an informal policy of "never telling a member to default." The Expert Group felt that perhaps the time had come for the Fund to call a spade a shovel.

A presumptive policy of Reprofiling will require the IMF to form a view about the appropriate treatment of holdouts from the Reprofiling exercise. Perhaps at some point in the future aggregated collective action clauses will deal with the holdout creditor problem, but that day is years down the road. For now, there are things the IMF could do to assist member countries in addressing the risks posed by holdout creditors.[5] A good starting point might be a candid admission that a Reprofiling policy will inevitably force member countries to confront the holdout problem.

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Attachment A:	Participants in the Annenberg House Experts Group
Attachment B:	Agenda for the November 2, 2013 meeting of the Expert Group

[4] As the April 26 paper notes, the recent apparent success of holdout creditors in Argentina and the decision of the Greek Government to pay holdouts from its 2012 restructuring in full, make holdout behavior in future sovereign debt restructurings more likely.

[5] Some of these options are discussed in a recent Brookings Institution Report, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2354998

Attachment A

THE ANNENBERG RETREAT AT SUNNYLANDS

USCGould
School of Law

THE ROLE OF THE IMF IN FUTURE SOVEREIGN DEBT RESTRUCTURING$
ANNENBERG HOUSE, SANTA MONICA, CALIFORNIA
NOVEMBER 2, 2013

RETREAT PARTICIPANTS

Mr. Douglas Baird, Harry A. Bigelow Distinguished Professor of Law, University of Chicago Law School

Ms. Nicole Bollen, Head of Unit for International Financial Institutions, Ministry of Foreign Affairs, Netherlands

Mr. Lee Buchheit, Partner and Counsel for Greece, Cleary Gottlieb & Hamilton LLP

Mr. Mitu Gulati, Professor, Duke Law School Visiting Professor of Law, USC Gould School of Law

Ms. Anne Krueger, Senior Research Professor of International Economics, Johns Hopkins School of Advanced International Studies (SAIS); Former Deputy Managing Director, IMF

Mr. Fridrik Mar Baldursson, Dean and Professor of Economics, Reykjavik University School of Business; Negotiator for Iceland, IMF

Mr. Robert Rasmussen, Dean and Carl Mason Franklin Chair in Law, USC Gould School of Law

Mr. David Skeel, S. Samuel Arsht Professor of Corporate Law, University of Pennsylvania Law School

Mr. Sergey Storchak, Deputy Finance Minister, Ministry of Finance of the Russian Federation

Mr. Jeromin Zettelmeyer, Deputy Chief Economist and Director of Research, European Bank for Reconstruction and Development

USC Gould School of Law

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The Annenberg Retreat at Sunnylands

The International Monetary Fund
and the Future of
Sovereign Debt Restructuring

November 2, 2013

Annenberg House
Santa Monica

Background reading:

1. IMF paper, "Sovereign Debt Restructuring -- Recent Developments and Implications for the Fund's Legal and Policy Framework" (April 26, 2013) (referred to below as "Recent Developments").

2. IMF Paper, "Greece -- Ex Post Evaluation of Exceptional Access Under the 2010 Stand-By Arrangement" (May 20, 2013) (referred to below as "Ex Post Evaluation").

3. "IMF Document Excerpts: Disagreements Revealed", Wall Street Journal (Oct 7, 2013).

4. Schadler, "Unsustainable Debt and the Political Economy of Lending: Constraining the IMF's Role in Sovereign Debt Crises", CIGI Working Paper # 19 (Oct 2013).

5. Salmon, "The IMF Revisits Sovereign Bankruptcy" Reuters (Oct 21, 2013).

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9:15 am Welcoming remarks

9:30 - 10:50 am Too Little and Too Late

Introduction

Roundtable discussion (all participants)

- How serious is the "too little and too late" problem discussed in paragraphs 21-33 of the Recent Developments paper?

- Should the Fund be given tools to pressure a debtor country into action earlier in the process?

- In practical terms, what can the Fund do to curtail the procrastination of debtor country authorities in commencing a needed debt rearrangement?

- To avoid the "too little" problem should the Fund openly prescribe the level of required debt relief early in the process?

- Should the Fund refuse to support a country that has asked for, or received, insufficient debt relief (in the Fund's opinion)?

- Should the Fund adopt (and publicly announce) objective criteria by which debt sustainability will be assessed (e.g., a target debt to GDP ratio as was done in the case of Greece 2012)?

- Is it appropriate for the Fund to suggest, or to accept, a differentiated treatment among private sector creditor groups (e.g., less severe restructuring terms for domestic financial institutions so as not to aggravate a local banking crisis)? What about retail investors?

- Should the Fund offer a financial inducement (such as longer maturities) for countries that address their debt problems sooner rather than later?

- Is the Fund equipped to withstand political pressures to defer a needed debt restructuring?

- Are fears of regional contagion, and the effect of a debt restructuring on banks located in important creditor countries, factors that should be taken into account in deciding whether to defer or cancel a needed debt restructuring?

10:50 – 11:00 am Summary of discussion

11:00 – 11:30 am Coffee

11:30 – 12:50 pm Bailing Out Private Sector Lenders

Introduction

Roundtable discussion (all participants)

- Are there ever circumstances in which Fund resources should be made available to repay in full and on time a debtor country's private sector lenders, other than in cases where country is (indisputably) facing only liquidity problems? See paragraph 31 of Ex Post Evaluation.

- Should there be a standard operating procedure for requiring, at the very least, a deferral of maturities of private sector debt during a program period?

- Should loss of market access be the presumptive trigger for such a mandatory stretch out?

- In some cases, this policy may force the debtor country into default on its existing debt. Should the Fund be more aggressive in supporting member countries in resisting demands of holdout creditors?

- What policy should the Fund adopt when other official sector lenders (such as neighboring countries) are prepared to lend the debtor country the money to repay private sector lenders in full? Should the IMF countenance such lending on the condition that the other official sector lenders acknowledge the Fund's preferred creditor status over such loans?

12:50 – 1:00 pm Summary of discussion

1:00 – 2:00 pm Lunch

2:00 – 3:20 pm The Fund's Role in Private Sector Debt Renegotiations

Introduction

Roundtable discussion (all participants)

- Should the Fund invite private sector or independent academic input on its debt sustainability analysis?
- Should the Fund be prepared to give a formal seal of approval to the restructuring terms being offered to private sector creditors?
- Should the Fund jettison its pretense of "neutrality" in a debtor country's negotiation with private sector lenders?
- Should the Lending Into Arrears policy be amended (e.g., to give greater clarity to the "negotiating in good faith" concept)?
- Should the Fund encourage or discourage the formation and operation of creditor committees?
- Has the time come to formalize the Fund's Preferred Creditor Status ("PCS")? If so, in what way and with what legal consequences?

3:20 – 3:30 pm	Summary of discussion
3:30 – 4:00 pm	Coffee
4:00 – 5:20 pm	The IMF and the Holdout Creditor Problem
	Introduction
	Roundtable discussion (all participants)

- Should the Fund be more aggressive in promoting techniques that minimize the holdout creditor problem in sovereign debt workouts?
- For example, should the Fund encourage/require the inclusion of enhanced aggregated collective action clauses in debt instruments of member countries? Should the Fund discourage the use of pari passu clauses that could give rise to injunctions requiring ratable payment of holdout creditors?
- Should the Fund reconsider its traditional bashfulness in expressing its views to courts considering holdout creditor litigation?

- Should the Fund sponsor or at least encourage financial assistance to poor countries facing legal demands from holdout creditors?

- Should the Fund (or some other IFI) increase technical assistance to member countries in areas such as the drafting and negotiation of financial contracts?

5:20 – 5:30 pm Summary of discussion

5:30 <u>Closing Remarks</u>

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