

## **Summary note on: Lessons learned from the debt crisis and ongoing work on sovereign debt restructuring and debt resolution mechanisms**

### **Special joint meeting of the UN GA Second Committee and the Economic and Social Council**

14 October 2014

#### **Background**

In General Assembly resolution 68/202 of 20 December 2013, Member States called for a special joint meeting of the Second Committee of the General Assembly and the Economic and Social Council during the 69<sup>th</sup> session to consider lessons learned from debt crises and the ongoing work on sovereign debt restructuring and debt resolution mechanisms, with the participation of relevant stakeholders. This was to build upon the special meeting of the Economic and Social Council on external debt sustainability and development, held on 23 April 2013. On 13 October 2014 the Second Committee considered the Secretary General's Report on External debt sustainability and development (A/69/167).

#### **Opening session**

The meeting was opened by **Ambassador Cardi of Italy** and **Ambassador Sajdik of Austria** in their respective capacities as Chair of the Second Committee of the General Assembly and President of ECOSOC. **Ambassador Cardi** emphasised the new urgency to address this issue as a result of the global financial crisis, and that the UN could contribute in a factual manner. He highlighted the need for more efficiency and coordination in dealing with debt crises, and that timely, effective, comprehensive and durable solutions were needed. He indicated that inclusive transparent and factual discussion with all stakeholders was paramount.

**Ambassador Sajdik** noted that problems related to sovereign debt are not confined to emerging markets or low income economies. Many countries in the developed world struggle with high debt burdens. Debt problems can be contagious, making them a threat to financial stability. He said there was a need to promote responsible lending and borrowing, debt management, and a need for fair burden sharing between debtors and creditors, as well as inter-creditor equity in debt restructuring. He perceived the need for fiscal consolidation, and that there is not yet agreement on the right approach to debt crisis resolution, some believed that improved contracts and a voluntary code of conduct is the answer, while others thought that a sovereign debt mechanism is the way forward.

#### **Session 1: Lessons learned from policy responses to contagion and debt crises and implications of the changing landscape for debt restructuring**

**Richard Kozul-Wright**, Director of the Division on Globalisation and Development Strategies at UNCTAD, then introduced the panellists of the first session and gave some introductory remarks. He noted that local and nationally issued debt has expanded in volume – presenting new financing opportunities but also new vulnerabilities. He explained that defaults can lead to uncertainty and are costly. He explained that public sector debt problems often begin as private sector debt problems, and noted an increase in private sector debt levels (including corporate debt) in the last few years. He argued that a more equitable and efficient process is needed which requires discussions at the international level.

**Mr. Antonio De Lecea**, Principal Advisor for Economic and Financial affairs for the European Union delegation to the United States, then presented the perspective of the EU. He underscored the division between two different types of debt problems – those with mainly public creditors and those with mainly private creditors – and emphasised the progress made in debt cancellation for low-income countries where the creditors were largely in the public sector. For debt restructuring, he noted that coordination is working well in some places though there are coordination problems that endanger success in other places, and agreed that recent developments show the need for the evolution of structures. Restructuring, in his view, is not just a question of legal feasibility but also carries the risk of contagion. He indicated that the EU supports the IMF’s role and leadership, including the recent work on reforming contractual language in bond issuances. From the EU experience, he emphasised three lessons learned: (1) the over-reliance on credit ratings which creates dangerous cliff effects in the international financial system and cited the new EU policy of reducing the reliance on them through regulation and supervision; (2) the need for stronger aggregation clauses in bond contracts; and (3) prevention of debt crisis is better than trying to cure one with a restructuring. He called restructuring “an extreme cure for an extreme circumstance”.

**Mr. Paulo Nogueira Batista**, Executive Director at the IMF representing Brazil and 10 other countries, speaking on behalf of his constituency, felt that the IMF had been rendered helpless in taking action to file an amicus brief in support of Argentina in the country’s fight against vulture funds in New York as it was hampered by its shareholding structure. He called the Argentina debt case unprecedented in that a country was forced to default because of the intervention of a judicial system of a single country.

He called the IMF’s progress this year on strengthening contractual clauses important, and welcomed its participation in the US Treasury-led initiative, which resulted in the changes in the contractual provisions of bond contracts. He discussed examples of use of the new provisions and indicated that there had been no first mover problems which might be an indication that the progress in improvements made maybe too little. In his view, the reforms were insufficient because of the existing large stock of bonds which are not covered by the new clauses. Countries remain vulnerable as exemplified by the ongoing problem in the Grenada debt restructuring which was being held up by a single creditor.

Mr. Batista argued that the UN has a role to play because it is a forum where all countries have greater voice. He noted that the UN resolution was approved by a majority of members (64% in favour, 6% opposed), but the minority opposed holds 39% of the voting power in the IMF. Meanwhile the 64% in favour, represent only 35% of the votes in the IMF. The UN resolution would have failed at the IMF, and thus the UN is a representative platform to play a balancing role in dealing with the remaining questions not resolved by changes in contractual clauses i.e., how to address the existing stock of debt? How to resolve the “too little too late” syndrome?

**Ms. Anna Gelpern** of Georgetown University was the final panellist of the session, and she argued that sovereign debt is bizarre because it is the only debt not directly enforceable, but it uniquely never goes it away. She said at least \$40 trillion in sovereign debt is in circulation, but the true vulnerability is hard to gauge because of unknown quantified contingent liabilities. Foreign law bonds account for \$900 billion of the total, with about \$500 billion of those issued by EMEs. She argued that the case of Argentina shows the weakness of foreign law debt – the holdout creditors still can not enforce on Argentina, they can only exact costs on other creditors.

Ms. Gelpern continued that debt management and debt restructuring must go together, and that both the quantity and the quality of the borrowing is important, asking whether the borrowing is legitimate. She argued that the UNCTAD principles for responsible borrowing and lending are important as a prism. She identified three problems in restructuring that need to be solved: efficiency, fairness, and legitimacy. Under efficiency she included criteria for the amount of restructuring and the timeliness of restructuring. Under fairness she emphasised burden sharing and problems of creditor fragmentation. Under legitimacy she included outcomes, participation, and the intelligibility of the process to its participants and stakeholders. In terms of solutions, she argued for a “modular framework”– a multiple part system that addressed each of the problems with specific solutions. She argued that the world should not obsess about the form of solutions (contractual approach vs. statutory approach), but needs to work on the three problems and design modules that can resolve them.

### **Major discussion points**

In the interactive discussion, the representative from Belgium asked Paulo Nogueira Batista what he thought the UN should focus on as distinct from the IMF. Mr. Batista explained that the main difficulty is for the official sector to deal with the overwhelming power of private finance to generate instability and destruction. He argued that the UN needs to contribute to rebalancing the relative influence of the private sector versus the official sector and has a role to oversee the work and make sure it comes out in a comprehensive and balanced way. He acknowledged the technical expertise of the IMF, but suggested that economists are not good at balance and subtlety, so the UN has a role to make sure any solutions are balanced and fair.

The representative from Japan emphasised that Japan takes the issue seriously, but that trying to develop a multilateral system through the UN in a rushed fashion is not helpful. He argued that designing a mechanism through the UN is not realistic when the IMF may be the relevant forum. He argued that any discussion requires the participation of all experts and stakeholders.

The representative of Ethiopia agreed that the UN should have a role, and suggested that the most important forum for discussing this issue is the upcoming Third International Financing for Development conference in July 2015. Ms. Gelpern argued that the UN has an agenda setting power that can bring the issue to the forefront of discussions. She also suggested that a repository of restructuring experience can be advanced by the UN. Mr. Batista said the third International Conference on Financing for Development will be an opportunity to review the work done between now and July. He stressed the governance issues and political imbalances in the IMF and suggested that a UN body should take the lead and work with IMF technical input. Mr. Kozul-Wright emphasised that the IMF is a creditor as well and this might contribute to the creditor bias in the international system. Ms. Gelpern argued that the UN should keep track of the overall agenda, identify problems and solutions, and guide the process.

The representative of Vietnam asked for clarification about Ms. Gelpern’s contention that the debt restructuring processes are unintelligible to all but a few specialists. Ms. Gelpern explained that there are a small number of law firms, creditors, multilateral officials, and other experts who worked repeatedly on sovereign debt restructuring and who have deep experience. She emphasised that the decentralised process empowers repeat players and a small number of people with expertise.

### **Session 2: Ongoing work on sovereign debt restructuring and debt resolution mechanisms**

The second session began with opening remarks by **Mr. Alex Trepelkov**, Director of the Financing for Development Office within the UN Department for Economic and Social Affairs. He argued that there was new urgency in the wake of the financial crisis, and that debt problems are now a global issue, not confined to developing countries. While noting the efforts for improving the architecture for debt restructuring, he indicated that there was still need to work on aligning incentives, preventing hold outs, dealing with too little and too late, ensuring speedy return to growth, predictability, fair burden sharing, equity among creditors, smooth functioning of debt markets, and global financing stability.

**Mr. Reza Baqir**, Chief of the Debt Policies at the IMF, spoke about the IMF's recent work on debt restructuring. He explained that the current wave of work started in June 2013, when the IMF board asked for step-by-step work in four areas to deal effectively with the complexity and nuance of the issue. Two elements were already started: work on strengthening contractual provisions of bond contracts, which was concluded in October and recently supported by its Board. This covered aggregation across different series of bond issues and the pari passu clause in bond contracts. The second element covered is the relationship between sovereign debt restructuring and the Fund's lending framework. On the latter, a preliminary discussion at the board was had in June 2014, and a final policy is expected to be adopted in the first quarter of 2015. The first key issue in this policy will be a decision on whether exceptional access to the Fund's resources should be granted without prior debt restructuring only on an assessment of "high probability" of debt sustainability or whether under cases of "reasonable probability" the Fund could help countries "reprofile" their debt rather than restructure as part of the lending package. The second key issue is whether the Fund should continue with the systemic exemption that allows the exceptional access to be granted without confidence in debt sustainability in cases where there might be systemic impacts or contagion. Two further areas of work will be developed after the lending framework policy is completed: (1) a new framework for official creditors now that Paris Club is no longer the only player; and (2) a lending into arrears policy – that sets out the correct process for the IMF when a country has defaulted.

**Ms. Yuefen Li**, Head of Debt and Development Finance at UNCTAD, commented on the IMF's work so far and presented UNCTAD's work programme. She welcomed the work on contractual bond provisions and encouraged its adoption but argued that these should not be considered as mutually exclusive to other approaches. She explained that the aspirations of the international community are for an orderly, timely, and fair mechanism and that there are still gaps to be filled and systemic questions that need to be discussed. She emphasised the problems of the existing stock of debt which was not covered by the IMF's recent work on contractual clauses, the vulnerability of small countries and low-income countries to vulture funds despite the new clauses, and the inherent unpredictability of future judicial interpretations of clauses in sovereign bond contracts.

Ms. Li explained that 13 countries have already endorsed the UNCTAD principles on sovereign borrowing and lending. Since 2013 she explained that UNCTAD has been working on the design of a debt workout mechanism building on a 2011 high-level meeting. She emphasised that UNCTAD has an inclusive working group, which has identified major problems: coordination, the legal forum, fragmentation, procrastination, and efficiency. The group has also elaborated a number of key principles, which have been refined with background papers and it will now work toward designing a restructuring framework.

**Ms. Benu Schneider**, Senior Economic Affairs Officer of the UN DESA Financing for Development Office, explained that there is a fragmented system for restructuring currently and that in the existing architecture there is no legal basis to prevent holdouts and litigation. Moreover, Paris Club

agreements have comparability of treatment from other creditors in the restructuring agreements with debtors, despite the fact that comparability of treatment has no legal basis, and very often this result in litigation by private creditors. There is a consensus that the recent Argentine litigation was a game changer – it will impact future debt restructurings by strengthening the hands of holdout. Experts support improvement in contractual technology but are of the view that something else is needed in addition – moreover there is still the problem of the existing debt stock and voluntariness with the current proposals to improve contractual technology. Work is undergoing in the DESA project for two further improvements – standstills in bond contracts vs. sovereign cocos which could also be achieved by a statutory measure amendment of article VIII2b. She argued that there are two types of restructurings: ones with no nominal “haircut” that happen relatively quickly but often do not help to bring down debt levels, and restructurings with deep haircuts that are often protracted and difficult. But there is always a massive reduction in growth before a default. Is this inevitable?

Ms. Schneider explained that UN DESA has been convening expert group meetings to enhance understanding between the different participants in restructurings – the private sector creditors, the official creditors, the debtor, and other stakeholders. She raised a number of issues where a consensus was emerging from the expert group meetings, including that: indicators of restructuring success were viewed differently by different stakeholders; delays (both in initiating negotiations and in completing negotiations) can worsen outcomes; and that the Fund’s lending into arrears there is an imbalance as there is no ‘good faith’ for the private sector in the Fund’s policy. She identified options for improving process questions such as ex-ante structures for creditor committees with a governance and oversight body vs the consultancy approach. She also called for an international debt registry for dealing with problems in timely and comprehensive debt data, and new research on how financial regulation may impede debt restructuring.

### **Major discussion points**

The representative of Ecuador argued that a lack of regulation has led to too-big-too-fail banks with such power that it allows them to undertake very high risk activities, thus privatizing profits and socializing losses. He argued for further cooperation at international and regional levels, including at the FfD conference, to ensure that societies dominate markets and not the other way around.

The representative of Guyana asked about the likelihood of copycat litigation after the Argentina case. The panellists agreed that copycat behaviour by holdout creditors is a real problem, with Grenada already facing the issue. There is an effort in forthcoming work by FFDO-DESA to engage partners and experts to develop safety clauses for small states, but as things stand, all future restructuring will be more complicated and difficult. Ms. Schneider explained that in a side event the previous week the panellists had felt it was likely that foreign law bond issuance may shift toward being issued under UK law to avoid the US law interpretation.

The representative of Brazil asked for follow-up actions to the presentations, and requested a summary as an important input to further deliberations.

Finally, Mr. Baqir made it clear that the majority of the IMF board does not support a treaty approach going forward and that a treaty approach that does not include issuing law countries (US/UK) would not address the collective action or holdout creditor problems.